

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

**For the three months ended June 30, 2010
Dated July 29, 2010**



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**Management's Discussion & Analysis
of Financial Condition and Results of Operations
For the three months ended June 30, 2010
Dated July 29, 2010**

The following is our discussion and analysis of the financial condition and results of operations for British Columbia Ferry Services Inc. as of July 29, 2010. This should be read in conjunction with our unaudited interim consolidated financial statements and related notes for the three month periods ended June 30, 2010 and 2009, and our fiscal 2010 audited consolidated financial statements and related notes together with our fiscal 2010 Management's Discussion & Analysis. These documents are available on SEDAR at www.sedar.com and on our Investor webpage at <http://www.bcferries.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. On June 15, 2010, we celebrated 50 years of service. Our service started with two vessels operating between Swartz Bay and Tsawwassen. Over the years we have grown to be one of the largest and most complex ferry systems in the world, providing frequent year-round transportation service on 25 routes, supported by 36 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 British Columbia.

During the three months ended June 30, 2010 (the first quarter of fiscal 2011), we provided over 46,000 sailings, carrying 5.3 million passengers and 2.1 million vehicles.

In the first quarter of fiscal 2011, we experienced a decline of 1.6% in vehicle traffic and 1.2% in passenger traffic as compared to the same period in the prior year. Drop-trailer, other commercial and over-height traffic increased, while buses, other vehicle traffic and passenger traffic experienced a decrease.

Significant events during or subsequent to our first quarter of fiscal 2011:

- On April 1, 2010, a fuel rebate of 2% of tariffs on average was implemented on our Major Routes. Fuel rebates of up to 5% of tariffs on average were in place on many of our other routes with the exception of our Northern Routes. On August 17, 2010, the fuel rebate on many of our other routes will be reduced from 5% to 2% of tariffs on average.
- On May 11, 2010, our new Vacations Centre in downtown Vancouver officially opened to the public. With the aid of an 11-meter long interactive media wall display, customers are able to view route maps, vessel schematics, and destination images to help them choose from a variety of travel package options. (See "Investing in our Capital Assets" below for more detail).
- On May 18, 2010, the 28-year-old *Quinsam* returned to service on one of our intra-island routes following an extensive \$19 million upgrade to prepare it for another 17 years of service. (See "Investing in our Capital Assets" below for more detail).
- On May 25, 2010 our "CoastSaver" program began. This promotional fare incentive program provides mid-week price discounts of 33% on passenger and passenger vehicle fares on our three Major Routes. This program was offered through July 29, 2010.

- May 26, 2010, we released the results of our 2009 Customer Satisfaction Tracking surveys which indicated that 91% of customers surveyed reported being satisfied with their overall trip experience, up from 86% in the prior year and the highest overall level of customer satisfaction reported since we began these surveys in 2003.
- On June 3, 2010, *Bill 20 – Miscellaneous Statutes Amendment Act (No.3), 2010* (Bill 20) received Royal Assent. Bill 20 amends several statutes, including the *Coastal Ferry Act* in response to the Comptroller General's Report on Review of Transportation Governance Models released November 6, 2009. It includes changes to the governance and regulatory framework within which we operate. By Order in Council dated June 24, 2010, the amendments to the *Coastal Ferry Act* were brought into force effective that date, except for certain sections which will be brought into force effective October 1, 2010. The costs to implement the regulatory, governance, and administrative changes resulting from Bill 20 are uncertain at this time.
- On July 1, 2010, the harmonized sales tax (HST) became effective, combining the existing 7% provincial sales tax with the 5% federal goods and services tax (GST) into a single tax of 12%. We expect this tax to add approximately \$5 to \$6 million annually to the cost of our operations. The HST will also increase the price to our customers for our food and certain retail offerings. Our vehicle and passenger tariffs which were exempt from GST will be exempt from HST.
- On July 28, 2010, the Canadian Accounting Standards Board issued an exposure draft "Adoption of IFRSs by Entities with Rate-regulated Activities" that proposes that qualifying entities with rate-regulated activities be permitted, but not required, to postpone adoption of International Financial Reporting Standards for a period of two years. (See "Accounting Practices" below for more detail).

FINANCIAL AND OPERATIONAL OVERVIEW

This section provides an overview of our financial and operational performance for the three months ended June 30, 2010 and 2009.

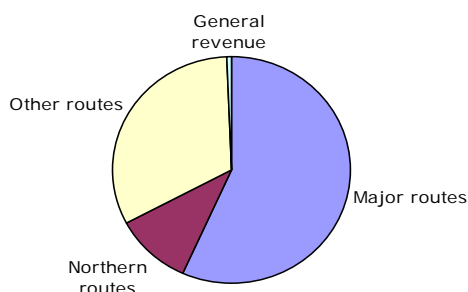
| (\$millions) | Three months ended June 30 | | | |
|--|----------------------------|---------|----------|---------|
| | 2010 | 2009 | Variance | |
| Total revenue | 190.2 | 178.3 | 11.9 | 6.7% |
| Expenses | (171.3) | (166.1) | (5.2) | (3.1%) |
| Earnings from operations | 18.9 | 12.2 | 6.7 | 54.9% |
| Interest and other | (18.0) | (15.8) | (2.2) | (13.9%) |
| Net earnings (loss) and comprehensive income | 0.9 | (3.6) | 4.5 | 125.0% |

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 of the year. The third and fourth quarters reflect a seasonal downturn in traffic and we utilize these off-peak periods to perform upgrades and major maintenance and refit programs, as well as to undertake mandatory inspections on the majority of our vessels.

Our earnings from operations in the three months ended June 30, 2010, were \$6.7 million higher and net earnings were \$4.5 million higher than the same period in the prior year.

Revenue

Our total revenue in the three months ended June 30, 2010 increased over the same period in the previous year as shown in the table below.



In the three months ended June 30, 2010, the greatest portion of our revenues, 59%, was earned on our three Major Routes connecting Vancouver Island to Vancouver and the Lower Mainland. The revenue from the Northern Routes contributed 10% and Other Routes contributed 31%.

| Revenue (\$millions) | Three months ended June 30 | | | |
|-----------------------------------|----------------------------|--------------|---------------------|-------------|
| | 2010 | 2009 | Increase (Decrease) | |
| Direct Route Revenue | | | | |
| Vehicle traffic (volume) | 2,099,035 | 2,132,848 | (33,813) | (1.6%) |
| Vehicle tariff | 73.9 | 67.7 | 6.2 | 9.2% |
| Passenger traffic (volume) | 5,327,594 | 5,391,803 | (64,209) | (1.2%) |
| Passenger tariff | 44.3 | 40.3 | 4.0 | 9.9% |
| Social program fees | 6.6 | 6.1 | 0.5 | 8.2% |
| Catering & on-board | 19.8 | 19.5 | 0.3 | 1.5% |
| Other revenue | 6.3 | 4.7 | 1.6 | 34.0% |
| Total Direct Route Revenue | 150.9 | 138.3 | 12.6 | 9.1% |
| Indirect Route Revenue | | | | |
| Ferry transportation fees | 31.9 | 32.2 | (0.3) | (0.9%) |
| Federal-Provincial subsidy | 6.7 | 6.7 | - | - |
| Total Route Revenue | 189.5 | 177.2 | 12.3 | 6.9% |
| Other general revenue | 0.7 | 1.1 | (0.4) | (36.4%) |
| Total Revenue | 190.2 | 178.3 | 11.9 | 6.7% |

Our largest revenue source is vehicle and passenger tariffs. The British Columbia Ferries Commissioner (the Commissioner) has authorized a price cap increase on the Major Routes of 2.7% plus 0.49 times the Consumer Price Index (CPI) (British Columbia) and 5.7% plus 0.73 times the CPI (British Columbia) on all other routes effective on each of April 1, 2010 and April 1, 2011. On April 1, 2010, the price caps increased by 2.68% on the Major Routes and 5.68% on all other routes, reflecting a change in the CPI (British Columbia) of -0.03%. In response, we implemented tariff increases up to the new level authorized.

From time to time, we utilize promotional fares 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 allowed increase in any one period.

Throughout the three months ended June 30, 2010, fuel rebates of 2% of tariffs on average were in place on our Major Routes and up to 5% of tariffs on average on many of our other routes. No fuel surcharges or rebates were in place on our Northern Routes. On August 17, 2010, the fuel rebate on many of our other routes will be reduced from 5% to 2% of tariffs on average.

Year to year changes for the three months ended June 30 for our Major, Northern and Other Routes are discussed separately below.

Major Routes

| Direct Route Revenue (\$ thousands) | Three months ended June 30 | | | |
|--|----------------------------|----------------|---------------------|--------------|
| | 2010 | 2009 | Increase (Decrease) | |
| Vehicle traffic (volume) | 953,382 | 962,151 | (8,769) | (0.9%) |
| Vehicle tariff | 54,855 | 49,376 | 5,479 | 11.1% |
| Passenger traffic (volume) | 2,747,339 | 2,744,158 | 3,181 | 0.1% |
| Passenger tariff | 32,139 | 28,555 | 3,584 | 12.6% |
| Social program fees | 3,167 | 2,974 | 193 | 6.5% |
| Catering & on-board | 16,229 | 15,887 | 342 | 2.2% |
| Reservation fees | 2,848 | 2,700 | 148 | 5.5% |
| Parking | 722 | 638 | 84 | 13.2% |
| Assured loading | 1,811 | 472 | 1,339 | 283.7% |
| Other revenue | 439 | 440 | (1) | (0.2%) |
| Total Direct Route Revenue | 112,210 | 101,042 | 11,168 | 11.1% |
| Indirect Revenue | | | | |
| Ferry transportation fees | - | - | - | - |
| Federal-Provincial subsidy | - | - | - | - |
| Total Route Revenue | 112,210 | 101,042 | 11,168 | 11.1% |

Our Major Routes consist of three regulated routes connecting Greater Vancouver with mid and southern Vancouver Island. Vehicle traffic decreased while passenger traffic increased in the three months ended June 30, 2010, compared to the same period in the previous year. Annual traffic levels on these routes are expected to be slightly lower than the prior fiscal year.



In the three months ended June 30, 2010, revenue from our Major Routes consisted of 97% from customers and 3% from social program fees.

Average tariff revenue per vehicle increased \$6.22 or 12.1% in the quarter, mainly as a result of higher tariffs and an increase in the number of commercial vehicles which carry higher individual fares. The higher average fares more than offset the reduction in traffic, resulting in an increase of \$5.5 million in vehicle tariff revenue. Average tariff revenue per passenger increased \$1.29 or 12.4%. The increase in passenger traffic and in average fares resulted in \$3.6 million higher passenger tariff revenue. The effects of being over the price cap at March 31, 2009 (and under at June 30, 2009) has caused the increase in average tariff revenue per vehicle and per passenger to be higher than the actual average tariff increase. Total tariff revenue for the quarter increased by \$9.1 million.

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 Ministry of Health Travel Assistance Program. Social program fees increased as a result of higher program usage and higher fares.

All vessels that provide service on our Major Routes have a gift shop and options for food service. Both food and gift shop sales increased as a result of higher passenger traffic and higher average spending per passenger. In our gift shops, sales of quality apparel remain strong with an increase of more than 20% over the same period of the prior year.

The increase in assured loading revenue reflects a gain relating to expired tickets. The increase in parking revenue reflects greater use of parking facilities at our Swartz Bay terminal largely due to higher passenger traffic originating at that terminal.

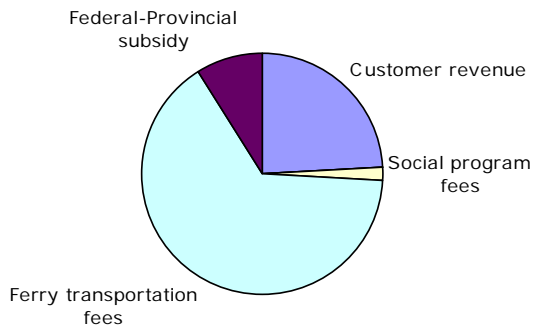
Other revenue decreased mainly as a result of lower retail commissions, mainly offset by an increase in hostling¹ fees from our drop-trailer service for commercial customers.

¹ Loading and unloading of commercial trailers that are dropped off for transportation on a ferry route

Northern Routes

| Direct Route Revenue (\$ thousands) | Three months ended June 30 | | | |
|--|----------------------------|---------------|---------------------|---------------|
| | 2010 | 2009 | Increase (Decrease) | |
| Vehicle traffic (volume) | 7,159 | 7,429 | (270) | (3.6%) |
| Vehicle tariff | 1,949 | 1,895 | 54 | 2.8% |
| | | | | |
| Passenger traffic (volume) | 19,696 | 20,103 | (407) | (2.0%) |
| Passenger tariff | 1,729 | 1,612 | 117 | 7.3% |
| | | | | |
| Social program fees | 304 | 226 | 78 | 34.5% |
| Catering & on-board | 529 | 543 | (14) | (2.6%) |
| Stateroom rental | 277 | 241 | 36 | 14.9% |
| Hostling & other | 53 | 62 | (9) | (14.5%) |
| Total Direct Route Revenue | 4,841 | 4,579 | 262 | 5.7% |
| | | | | |
| Indirect Revenue | | | | |
| Ferry transportation fees | 12,236 | 12,525 | (289) | (2.3%) |
| Federal-Provincial subsidy | 1,665 | 1,665 | - | - |
| | | | | |
| Total Route Revenue | 18,742 | 18,769 | (27) | (0.1%) |

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 30, 2010, revenue from our Northern Routes consisted of 24% from customers and 76% from the Province (2% social program fees, 65% ferry transportation fees, and 9% from payments under the Federal-Provincial subsidy agreement).

Northern Routes, cont'd

Both vehicle traffic and passenger traffic decreased in the three months ended June 30, 2010, compared to the same period in the previous year. Although there was a decrease in the quarter, we anticipate annual traffic levels to be marginally higher than the prior fiscal year.

The average tariff revenue per vehicle increased \$17.16 or 6.7%, mainly as a result of higher fares for commercial vehicles. The average tariff revenue per passenger increased \$7.60 or 9.5%. The reduction in traffic was more than offset by the increase in average fares, resulting in a total tariff revenue increase for the quarter of \$0.2 million.

Reimbursements from the Province for social program fees increased as a result of higher usage and higher average fares. Revenue from catering and on-board services has decreased as a result of lower traffic levels. Despite the decline in passenger traffic, stateroom rental revenue has increased largely due to the entry into service of the *Northern Expedition* on May 18, 2009.

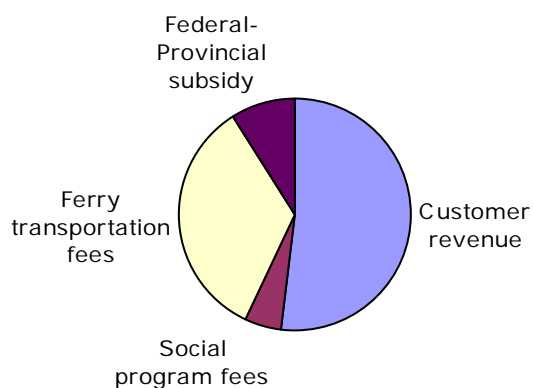
We receive ferry transportation fees for these routes under the Coastal Ferry Services Contract. These fees are lower in the quarter, reflecting the lower net book value of the vessels used on these routes, partially offset by a higher number of round trips during the same period in the prior year. The total annual transportation fees are expected to be \$0.5 million lower than the prior fiscal year.

The Federal-Provincial subsidy this fiscal will be equal to the prior year reflecting no change in the annual CPI (Vancouver).

Other Routes

| Direct Route Revenue (\$ thousands) | Three months ended June 30 | | | |
|--|----------------------------|---------------|---------------------|-------------|
| | 2010 | 2009 | Increase (Decrease) | |
| Vehicle traffic (volume) | 1,138,494 | 1,163,268 | (24,774) | (2.1%) |
| Vehicle tariff | 17,140 | 16,423 | 717 | 4.4% |
| Passenger traffic (volume) | 2,560,559 | 2,627,542 | (66,983) | (2.5%) |
| Passenger tariff | 10,400 | 10,182 | 218 | 2.1% |
| Social program fees | 3,111 | 2,856 | 255 | 8.9% |
| Catering & on-board | 2,713 | 2,811 | (98) | (3.5%) |
| Reservation fees | 328 | 332 | (4) | (1.2%) |
| Parking & other | 112 | 90 | 22 | 24.4% |
| Total Direct Route Revenue | 33,804 | 32,694 | 1,110 | 3.4% |
| Indirect Revenue | | | | |
| Ferry transportation fees | 19,713 | 19,653 | 60 | 0.3% |
| Federal-Provincial subsidy | 5,066 | 5,066 | - | - |
| Total Route Revenue | 58,583 | 57,413 | 1,170 | 2.0% |

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 transportation fees in the above table.



In the three months ended June 30, 2010, revenue from our Other Routes consisted of 52% from customers and 48% from the Province (5% social program fees, 34% ferry transportation fees, and 9% from payments under the Federal-Provincial subsidy agreement).

Other Routes, cont'd

Both vehicle traffic and passenger traffic decreased in the three months ended June 30, 2010, compared to the same period in the previous year. We expect annual traffic levels on these routes to be slightly lower than the prior fiscal year.

The average tariff revenue per vehicle increased \$0.94 or 6.6% while the average tariff revenue per passenger increased \$0.19 or 4.8%. The reduction in traffic was more than offset by the increase in average fares, resulting in higher total tariff revenue for the quarter of \$0.9 million.

On August 17, 2010 fuel rebates on the majority of these routes will decrease from 5% to 2% of tariffs on average.

Reimbursements from the Province for social program fees increased as a result of higher fares, partially offset by lower usage.

Revenue from catering and on-board services decreased primarily as a result of the closure of the cafeteria and retail areas on the *Queen of Burnaby* for approximately one month as some asbestos abatement work was being done in these areas. Fees for reservations decreased primarily as a result of lower traffic levels on routes where those services are offered.

Ferry transportation fees are slightly higher in the quarter. However, total annual transportation fees are expected to equal that of the prior fiscal year.

The Federal-Provincial subsidy this fiscal will be equal to the prior year reflecting no change in the annual CPI (Vancouver).

Expenses

Expenses for the three months ended June 30, 2010 and 2009 are summarized in the tables below.

| Operating expenses (\$ millions) | Three months ended June 30 | | |
|--|----------------------------|--------------|------------------------|
| | 2010 | 2009 | Increase (Decrease) |
| Operations | 103.6 | 100.5 | 3.1 3.1% |
| Maintenance | 23.8 | 23.7 | 0.1 0.4% |
| Administration | 7.5 | 7.4 | 0.1 1.4% |
| Total operations, maintenance & administration | 134.9 | 131.6 | 3.3 2.5% |
| Cost of retail goods sold | 7.7 | 7.5 | 0.2 2.7% |
| Amortization | 28.7 | 27.0 | 1.7 6.3% |
| Total expenses | 171.3 | 166.1 | 5.2 3.1% |

The \$3.1 million increase in operations expenses mainly consists of:

- \$1.4 million increase in wages and benefits, mainly as a result of wage rate increases averaging about 3% in accordance with the existing Collective Agreement;
- \$0.6 million or 2.5% increase in fuel expense as a result of higher approved prices and a 0.4% increase in fuel consumption;
- \$0.4 million in advertising costs for the launch of our new Vacations Centre; and
- \$0.4 million for water taxi and barge service on a northern route while the *Nimkish* was undergoing a refit.

The \$0.1 million increase in maintenance costs reflects an increase in terminal maintenance, partially offset by lower vessel maintenance as a result of variations in vessel refit scheduling.

The \$0.1 million increase in administration expenses is mainly as a result of higher annual information technology licence fees and support costs, partially offset by a reduction in wages and benefits.

Amortization increased a total of \$1.7 million, including \$1.4 million due to the *Northern Expedition* commencing service in May 2009.

| Interest and other (\$ millions) | Three months ended June 30 | | |
|---------------------------------------|----------------------------|-------------|------------------------|
| | 2010 | 2009 | Increase (Decrease) |
| Interest expense | | | |
| Bond interest | 15.8 | 15.8 | - |
| KfW loans | 2.7 | 2.9 | (0.2) |
| Short-term loans | 0.1 | 0.1 | - |
| Interest on deferred accounts | 0.1 | - | 0.1 |
| Structured Financing Facility Program | (0.1) | (1.3) | 1.2 |
| Capitalized interest | (0.6) | (1.7) | 1.1 |
| Total interest and other | 18.0 | 15.8 | 2.2 |

Interest expenses increased \$2.2 million primarily due to:

- \$1.2 million less interest rate support received from the Government of Canada. Final amounts relating to the *Queen of New Westminster* and the *Island Sky* support funding were received in April 2010 and January 2010, respectively; and
- \$1.1 million less interest capitalized this quarter reflecting a lower capital program.

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. Over the next five years, we expect our cash requirements will be met through operational cash flows and by accessing our credit facility from time to time. At June 30, 2010, our unrestricted cash and cash equivalents totalled \$6 million and our credit facility was undrawn.

We target maintaining a strong investment-grade credit rating to allow capital market access at reasonable interest rates. Our credit ratings at June 30, 2010, were A (DBRS) and A+ (Standard & Poor's), both with a stable trend.

Sources and Uses of Cash

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

Sources and uses of cash and cash equivalents for the three months ended June 30, 2010 and 2009 are summarized in the table below:

| (\$ millions) | Three months ended June 30 | |
|--|----------------------------|--------|
| | 2010 | 2009 |
| Net earnings (loss) | 0.9 | (3.6) |
| Items not involving cash: | | |
| Amortization | 28.7 | 27.0 |
| Other non-cash charges | 0.4 | (0.7) |
| Regulatory costs deferred | (2.3) | 2.7 |
| Change in non-cash operating working capital | (11.3) | (1.8) |
| Cash provided by operating activities | 16.4 | 23.6 |
| Cash (used) provided by financing activities | (0.1) | 1.9 |
| Cash used in investing activities | (20.8) | (22.5) |
| Total (decrease) increase in cash and cash equivalents | (4.5) | 3.0 |

In the three months ended June 30, 2010, cash provided by operating activities included \$2.3 million of cash used to reduce regulatory liabilities as follows:

- \$3.2 million in fuel rebates granted; partly offset by
 - \$0.5 million in fuel and interest costs deferred; and
 - \$0.4 million in other payments from the Province credited to deferred fuel accounts

For the same period, cash provided by operating activities also included an increase in non-cash operating working capital of \$11.3 million. This increase in non-cash operating working capital was due to:

- \$6.0 million increase in prepaid expenses primarily due to \$2.8 million in property taxes, \$1.7 million in fuel, \$0.8 million in IT licence fees, and \$0.5 million in insurance;
- \$3.2 million increase in accounts receivable primarily due to:
 - \$2.4 million in social program fees receivable; and
 - \$1.8 million in commercial accounts receivable due to increased sales volume; partially offset by
 - \$0.8 million received through the Government of Canada's Structured Financing Facility (SFF) program;
- \$3.1 million reduction in interest payable on long-term debt;
- \$1.1 million reduction in accrued employee costs; and
- \$0.1 million increase in total inventories.

The above items, which increased non-cash operating working capital, were partially offset by:

- \$2.1 million increase in deferred revenue for prepaid reservations as we approach our peak summer season; and
- \$0.1 million increase in payables and accrued liabilities relating to refit and maintenance and other operating activities.

Cash used in investing activities consists mainly of \$20.6 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, 2010, totalled \$26.0 million, as follows:

| | (\$ millions) |
|--|---------------|
| Terminal marine structures | 10.3 |
| Information technology | 7.3 |
| Terminal and building upgrades and equipment | 5.3 |
| Vessel upgrades and modifications | 3.1 |
| Total capital expenditures | <u>26.0</u> |

Terminal Marine Structures

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

| Terminal | Description | (\$ millions) |
|-----------------|--|---------------|
| Tsawwassen | Major berth replacement and refurbishment | 7.5 |
| Campbell River | Replacement of wingwalls and dolphins | 1.1 |
| Quathiaski Cove | Replacement of ramp, wingwalls, towers and shelter | 0.7 |
| Various | Other projects | 1.0 |
| | | <u>10.3</u> |

The \$39 million replacement and refurbishment of one of the berths (berth 4) at Tsawwassen terminal is a multi-year project to replace all 13 dolphins, the port wingwall and the lower ramp. The lower ramp will be replaced with a new multi-apron ramp with two-lane commercial vehicle capacity and the foundations and ramp supports will be upgraded and a new hydraulic lift system installed. The expenditures at Tsawwassen terminal also include \$0.7 million of a \$5 million project for concrete restoration and full seismic upgrade of the transfer deck between berths 3 and 4.

Information Technology

Capital expenditures on information technology in the quarter included the following:

| | (\$ millions) |
|-------------------------------------|---------------|
| Oracle enterprise licence software | 4.1 |
| Payroll system replacement | 0.8 |
| Customer service system replacement | 0.5 |
| Website enhancements | 0.3 |
| Other projects | 1.6 |
| | <u>7.3</u> |

As part of our ongoing processes, we have reviewed and updated our enterprise wide Oracle licences.

The payroll system replacement initiative is a \$3 million project that will replace both our payroll and labour distribution systems to provide significant processing efficiencies and flexibility..

The customer service system initiative is in the preliminary stages to replace our point of sale and reservations systems to provide enhanced functionality and more efficient customer service.

The website initiative is a \$4 million project to improve customer service and communications tools, both internally and externally, and to establish a technical platform to enable future web enhancements.

Terminal and Building Upgrades and Equipment

Capital expenditures on terminal and building upgrades and equipment included the following:

| | (\$ millions) |
|-------------------------------------|---------------|
| Terminal waste water program | 1.7 |
| Vehicles, machinery & equipment | 1.1 |
| Departure Bay terminal improvements | 0.9 |
| Seismic upgrades | 0.7 |
| Vacations Centre | 0.4 |
| Security upgrades | 0.3 |
| Other terminal projects | 0.2 |
| | <u>5.3</u> |

As part of the multi-year sewage and waste water treatment program for treatment of sewage generated onboard our vessels, connection of Swartz Bay terminal to the existing municipal infrastructure has been completed, allowing us to transfer sewage from our smaller vessels operating out of this terminal. Construction of a holding tank at the terminal to accommodate sewage from our larger vessels will follow. This will allow transfer to the municipal infrastructure to occur during off-peak periods.

The costs incurred for vehicles, machinery, and equipment include the purchase of a crane truck in the third year of our five-year heavy vehicle replacement program. This new vehicle replaced an 18-year-old crane truck which we donated to Camosun College of Victoria for use in their heavy duty mechanics program. We also continued with the second year of our two-year program with the purchase of three additional hostling units to support our new drop-trailer service. These units will be used to move commercial trailers to and from our holding compounds.

We are nearing completion of our multi-year program in accordance with our master plan for improvements at Departure Bay terminal. These improvements have included new retail and ticket buildings, a new waiting room, consolidation of waste management facilities and expansion of customer and employee parking. The last stage which includes reconfiguration of the holding compound and employee and customer parking lots as well as construction of a canopy is expected to be completed this fiscal year.

On May 11, 2010, we officially opened our new Vacations Centre in downtown Vancouver. The centre is conveniently located in the new Fairmont Pacific Rim property in the heart of the tourist sector in downtown Vancouver. Using an interactive media wall display, customers are able to view route maps, vessel schematics, and destination images to help them choose from a variety of travel package options.

At nine terminals, mainly serving our Major and Northern Routes, we continued our multi-year project to upgrade 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. We received \$9.1 million (including \$3.2 million this quarter) of federal funding through the Transport Canada Marine Security Contribution Program to help offset our costs of perimeter security, access control measures, and training.

Vessel Upgrades and Modifications

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

| | (\$ millions) |
|---|---------------|
| <i>Quinsam</i> upgrade and betterment | 0.9 |
| <i>Quadra Queen II</i> life extension | 0.6 |
| Completion of <i>Queen of Oak Bay</i> shore power synchronization | 0.3 |
| Sewage treatment upgrade program | 0.2 |
| Other projects | 1.1 |
| | <u>3.1</u> |

The 28-year-old *Quinsam* returned to service on May 18, 2010, after completion of an extensive \$19 million asset betterment project to prepare the vessel for another 17 years of service. The betterment included hull steel renewal, new lifesaving systems, new electrical switchboard and generators, new right-angle drives, upgrades to the engines, new sewage tank and macerator and various interior improvements. This quarter we submitted claims for \$1.0 million of interest rate support payments relating to the life extension of the *Quinsam* through the SFF program.

The project to extend the life of the 41-year-old *Quadra Queen II* began in May 2010. This \$15 million project will include hull steel renewal, new propellers and bow thruster, new generators, new instrumentation and control systems, new lifesaving systems and various interior improvements. This project will prepare the vessel for a further 15 years of service. On April 13, 2010, we received approval for up to \$1.8 million of additional interest rate support payments through the SFF program relating to this life extension which is expected to be completed by the end of this fiscal year.

Implementation of a multi-year sewage and waste water treatment program to upgrade 20 vessels and eight terminals for treatment of sewage generated onboard the vessels continues. The program involves major modifications and upgrades to ensure that all vessels comply with new *Canada Shipping Act, 2001* sewage regulations, which will apply effective July 1, 2012. Wherever possible, the vessels will convey sewage to a terminal through pump-ashore infrastructure. In all other cases, the vessels will be fitted with compliant marine sanitation devices. Modification of the first two vessels, the *Skeena Queen* and the *Kwuna*, is complete. As part of the Federal government's Infrastructure Stimulus Fund program, we estimate we will receive \$7.5 million to assist with sewage pump-ashore projects and other major terminal projects.

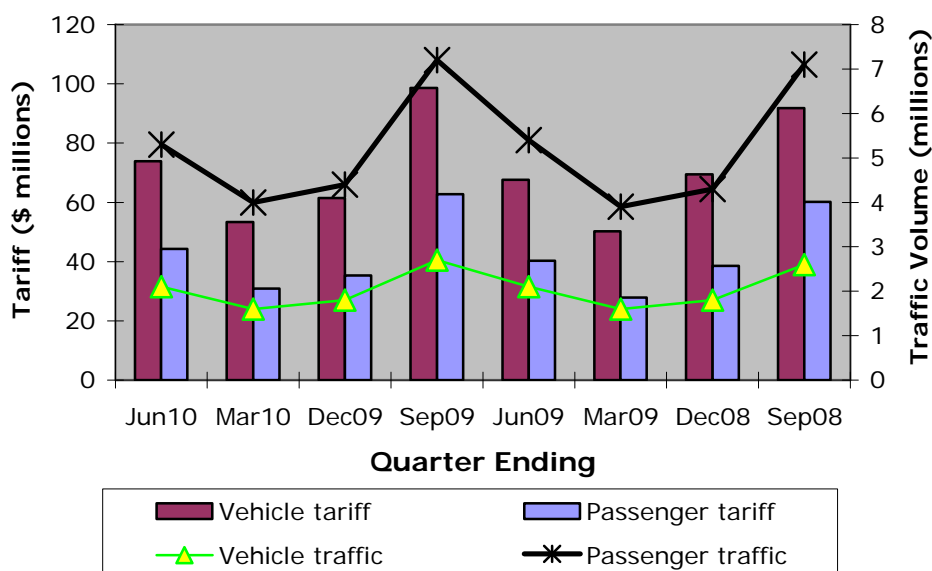
SUMMARY OF QUARTERLY RESULTS

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

| (\$ millions) | Quarter Ended (unaudited) | | | | | | | |
|--|---------------------------|--------|--------|--------|--------|--------|--------|--------|
| | Jun 10 | Mar 10 | Dec 09 | Sep 09 | Jun 09 | Mar 09 | Dec 08 | Sep 08 |
| Total revenue | 190.2 | 142.3 | 159.9 | 251.8 | 178.3 | 128.5 | 149.4 | 232.1 |
| Earnings (loss) from operations | 18.9 | (19.5) | (1.9) | 81.5 | 12.2 | (25.1) | (1.7) | 66.2 |
| Net earnings (loss) and comprehensive income | 0.9 | (36.8) | (20.4) | 64.2 | (3.6) | (38.4) | (14.6) | 53.7 |

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 reduction 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.



FINANCIAL RISKS AND FINANCIAL INSTRUMENTS

Exposure to credit risk, liquidity risk and market risk arises in the normal course of our business. We manage market risk arising from the volatility in foreign currency, interest rate, and fuel price exposures in part through the use of derivative financial instruments including forward contracts, swaps and options. We do not utilize derivative financial instruments for trading or speculative purposes.

A discussion of financial risks can be found on pages 35 through 37 of our fiscal 2010 Management's Discussion & Analysis. Our risk profile is substantially unchanged during the three months ended June 30, 2010.

BUSINESS RISK MANAGEMENT

Understanding and managing operational risk is an important part 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 on pages 38 through 45 of our fiscal 2010 Management's Discussion & Analysis. Our risk profile is substantially unchanged during the three months ended June 30, 2010.

We do not believe that material uncertainties exist in regards to our future. We have considered many items such as profitability levels, cash generating potential, cash utilization requirements including debt repayment schedules and future capital expenditures, and working capital requirements. We have taken measures to allow us to weather the economic downturn and continue to have a viable, profitable future.

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, 2010 and June 30, 2010 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 46 through 48 of our fiscal 2010 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, 2010, or expect to use in the future.

Adoption of New Accounting Standards

No new accounting standards have been adopted for fiscal 2011.

Future Accounting Changes

The following is a discussion of accounting changes that will be effective for us in future periods:

- 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 IFRS over an expected five year transitional period. Our transition date for the conversion to IFRS is currently April 1, 2011, although recent developments related to rate-regulated activities may result in this transition date being postponed to April 1, 2013. (See "rate-regulated operations" below for more detail). Transition to IFRS will require the restatement for comparative purposes of amounts reported by us for the year prior to transition date. We are continuing to assess the financial reporting impacts of the adoption of IFRS and are monitoring ongoing standards development as issued by the International Accounting Standards Board and the AcSB as well as regulatory developments as issued by the Canadian Securities Administrators, which may affect the timing, nature or disclosure relating to our adoption of IFRS.

The transition to IFRS may materially affect our reported financial position and results of operations. As our analysis is still underway and significant uncertainty exists regarding the accounting for rate-regulated activities under IFRS, we are unable to quantify the impact of IFRS on the future financial position and results of operations.

We commenced our IFRS transition project in 2007 and have established a formal project governance structure with regular reporting. We have also engaged a quality assurance advisor to assist in the project.

Our IFRS transition project consists of three phases:

1. Scoping and diagnostic phase, which has been completed, involved project planning and resourcing, high level impact assessment of differences between current Canadian GAAP and IFRS, and priority setting;
2. Analysis and development phase which involves detailed analysis and evaluation of options and alternative methodologies available under IFRS, and the financial impact of these options; and
3. Implementation and review phase which involves implementing and approving changes to accounting policies, information systems, business processes and training, and developing IFRS-compliant financial statements.

We are currently in either the analysis and development stage or the implementation and review stage, depending on the specific area.

The following table includes elements of our IFRS transition plan and an assessment of progress towards achieving the key milestones. We are working through a detailed IFRS transition plan and certain project activities and milestones could change. Further, changes in regulation or timing of standard development throughout the project could result in changes to the transition plan.

| |
|---|
| <p>Financial statement preparation</p> <p>Key activities</p> <ul style="list-style-type: none"> • Identify differences in Canadian GAAP/IFRS accounting policies • Select ongoing IFRS policies • Develop financial statement format • Select IFRS 1 exemptions for transition • Quantify effects of change at April 1, 2010 (for fiscal 2011 comparative financial statements) <p>Milestones</p> <ul style="list-style-type: none"> • Senior management review of policy decisions and illustrative IFRS financial statements and disclosures by June 30, 2010 • Audit & Finance Committee approval of policy decisions and IFRS financial statement format, in principle, by September 30, 2010 • IFRS 1 exemptions finalized and quantified by September 30, 2010 • Policies and procedures in place by March 31, 2011 <p>Status</p> <ul style="list-style-type: none"> • Scoping and diagnostic phase completed in fiscal 2009, with high-level review of the major differences between Canadian GAAP and IFRS • Highest areas of impact identified; review prioritized; and in-depth analysis complete in most areas • Accounting policy alternatives have been analyzed, recommendations made for the majority of key accounting policy decisions • IFRS 1 exemptions reviewed and analyzed • Preparation of illustrative financial statements and note disclosures complete • Audit & Finance Committee approval of the illustrative financial statement format has been deferred pending the outcome of the current AcSB exposure draft • Drafting of policies and procedures in progress |
| <p>Information technology infrastructure</p> <p>Key activities</p> <ul style="list-style-type: none"> • Confirm system upgrades required for IFRS reporting • Review/revise data gathering processes • Review/revise budgeting and forecasting processes <p>Milestones</p> <ul style="list-style-type: none"> • System configuration changes complete by March 31, 2010 • System reporting changes required to accommodate both current Canadian GAAP and IFRS complete by August 31, 2010 • Changes to budgeting and forecasting processes complete by September 30, 2010 <p>Status</p> <ul style="list-style-type: none"> • Detailed reporting requirements to accommodate the transition to IFRS identified and documented • Overall system approach selected • System configuration to accommodate both current Canadian GAAP and IFRS complete • System changes to accommodate reporting requirements on schedule for implementation prior to August 31, 2010 • Changes to budgeting and forecasting processes in progress |

| |
|--|
| <p>Training, Education & Communication</p> <p>Key activities</p> <ul style="list-style-type: none"> • Determine required level of IFRS expertise within all areas of the company • Ensure appropriate training of key members within Finance • Provide appropriate education and communication to affected departments • Provide department specific training on revised policies and procedures • Provide timely communication to both internal and external stakeholders on impacts of the transition to IFRS |
| <p>Milestones</p> <ul style="list-style-type: none"> • Topic-specific training for IFRS working committee complete prior to March 31, 2010 • Department-specific training completed by March 31, 2011 • Impacts of transition to IFRS communicated to external stakeholders by March 31, 2011 |
| <p>Status</p> <ul style="list-style-type: none"> • Core IFRS project team members completed topic-specific training, and successfully completed the "IFRS Award Program, Certificate Level" through the Institute of Chartered Accountants in England and Wales • Interdepartmental workshops provided on specific topics, including property, plant and equipment; IFRS 1; and the IFRS Framework • Training requirements identified and training plan developed as implementation plans progress • Ongoing communications with key stakeholders, including direct communication with the Commissioner, our Agent Bank, rating agencies, our Board of Directors, and with investors indirectly through our website |
| <p>Control environment</p> <p>Key activities</p> <ul style="list-style-type: none"> • Accounting policy determination, documentation and implementation • MD&A ongoing communications |
| <p>Milestones</p> <ul style="list-style-type: none"> • All internal control process descriptions updated by March 31, 2011 • Publish quantitative effects of conversion on April 1, 2010 opening balance sheet in December 31, 2010 MD&A (assuming decisions regarding regulatory assets and liabilities are known) |
| <p>Status</p> <ul style="list-style-type: none"> • Analysis of control issues in progress as part of the detailed implementation plan • Documentation of policies and procedures in progress |
| <p>Business policy assessment</p> <p>Key activities</p> <ul style="list-style-type: none"> • Financial covenants assessment • Compensation arrangements assessment • Customer and supplier contract evaluation |
| <p>Milestones</p> <ul style="list-style-type: none"> • Potential impact on compensation arrangements determined by December 31, 2010 • Impact on customer/supplier contracts determined by December 31, 2010 • Impact on financial covenants quantified by March 31, 2011 |
| <p>Status</p> <ul style="list-style-type: none"> • All relevant GAAP-dependent covenants and contracts have been identified • Analysis to determine effects of IFRS on existing covenants and contracts in progress |

A summary of progress in the review of areas identified to have the highest potential to impact us is as follows:

- Rate-regulated operations: IFRS does not currently provide specific guidance with respect to accounting for rate-regulated activities. However, in December 2008, the International Accounting Standards Board (IASB) initiated a project on accounting for rate-regulated activities that has an objective to develop a standard on rate-regulated activities that would clarify whether regulated entities could or should recognize assets or liabilities as a result of rate-regulation imposed by a regulatory body.

On July 23, 2009, the IASB published an Exposure Draft "Rate-regulated Activities" (ED) to define regulatory assets and regulatory liabilities, set out criteria for their recognition, specify how they should be measured and require disclosures about their financial effects. We reviewed this ED and responded to the IASB requesting clarification of scope as defined in the ED. More than 150 comment letters with significantly differing comments and views were received by the IASB.

At its February 2010 meeting, the IASB began discussions on the responses to the ED. They also discussed the logistical considerations impacting the rate-regulated activities project. The IASB did not make any tentative decisions on specific aspects of the project, except to tentatively finalize an amendment to IFRS 1 to provide transition relief for first-time adopters. This amendment was published on May 6, 2010 and provides an exemption for property, plant and equipment and intangible assets used in operations subject to rate regulation. A first-time adopter may elect to use, on an item by item basis, the previous GAAP carrying amount of such items as deemed cost at the date of transition to IFRS. We have assessed the impact of the options available as a result of this IFRS 1 amendment and have decided to adopt the exemption for all of our intangible assets and the majority of our items of property, plant and equipment.

The IASB staff has performed significant research and analysis focusing on the key issue of whether regulatory assets and liabilities exist in accordance with the current Framework for the Preparation and Presentation of Financial Statements and whether they are consistent with other current IFRS standards. This issue was deliberated at the July 2010 meetings of the IASB but no decisions were made.

The IASB instructed its staff to continue the current research, analysis and deliberations on this project as time and resources permit. A revised timeline for completion of the rate-regulated activities project was not proposed. The IASB staff estimate indicated the issuance of a final standard during the second half of 2011 but the IASB did not discuss the appropriateness of this timing.

On July 28, 2010, the AcSB issued an exposure draft "Adoption of IFRSs by Entities with Rate-regulated Activities" proposing that qualifying entities with rate-regulated activities be permitted, but not required, to continue applying existing Canadian GAAP for an additional two years. As we would be a qualifying entity, this would provide us with an option to postpone our transition date for conversion to IFRS until April 1, 2013. Comments on the exposure draft must be submitted by August 31, 2010 and the proposed amendment is expected no later than December 2010. It is our intention to elect this deferral option if and when it is made available.

The continued uncertainty regarding IFRS treatment of regulatory assets and liabilities has resulted in an inability to reasonably estimate and conclude the impact of IFRS on our future financial position and results of operations with respect to differences, if any, in accounting for rate-regulated activities.

- Property, plant and equipment:
 - *Inspections and major overhauls:* The capitalization of inspections and major overhauls of our vessels is the largest change affecting us. A process to track these items has been finalized and necessary system configuration changes have been completed. We are currently in the process of:
 - ▶ defining and identifying inspection and major overhaul items for each class of vessel;
 - ▶ quantifying those inspections and major overhauls for reclassification of property, plant and equipment at transition date; and
 - ▶ determining the best solution for reporting of these costs.
 As the analysis is in progress, the effect on our consolidated financial statements of the adoption of this guidance cannot be quantified at this time.
 - *Valuation subsequent to transition:* We have a choice under IFRS to value our property, plant and equipment using either a historical cost model or a revaluation model. We have decided to use a historical cost model for all property, plant and equipment with the exception of land. We will use a revaluation model for our land.
- IFRS 1 *First-Time Adoption of IFRS:* All elections and exemptions under IFRS 1 have been reviewed. The exemptions that apply to us upon adoption are summarized as follows:
 - *Employee Benefits:* There is a choice to either recognize all cumulative actuarial gains and losses of defined benefit plans through opening retained earnings or recalculate the actuarial gains and losses under IFRS from the inception of the defined benefit plans. We have elected to recognize all cumulative actuarial gains and losses through opening retained earnings at April 1, 2010.
 - *Property, plant and equipment and Intangible assets:* There is a choice of valuation of property, plant and equipment and intangible assets at April 1, 2010, either to:
 - retrospectively apply IFRS to the valuation of the assets; or
 - to revalue items, on an asset by asset basis, at fair value and use that fair value as deemed cost; or
 - to use previous GAAP carrying amounts at transition as the deemed cost for assets used in rate-regulated operations.

We have elected to use previous GAAP carrying amounts at transition as the deemed cost for all intangible assets and the majority of our property, plant and equipment with the exception of land. We have elected to revalue land at fair value at April 1, 2010.

As actuarial valuations of our defined benefit plans at April 1, 2010 have not yet been completed, the effect on our consolidated financial statements of the adoption of IFRS 1 cannot be quantified at this time.

- Intangible assets: There is substantially no change in IFRS from Section 3064, *Goodwill and Intangible Assets*, which we adopted April 1, 2009. The adoption of this guidance is not expected to have any significant effect on our consolidated financial statements.
- Asset impairment: We are currently defining indications of impairment. Processes to track any asset impairment and potential subsequent reversals have been determined. The adoption of this guidance is not expected to have any significant effect on our consolidated financial statements.

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, construction costs, the state of the local economy, turbulent financial markets, demographics, import duties remission, tax changes, and the requirements of the Coastal Ferry Services Contract.

Forward looking statements included in this document include statements with respect to our short and long-range business plans, estimates of future customer demand, asset renewal programs for vessels and terminals, expectations of the ferry transportation fee amounts, expectations of funding under the Infrastructure Stimulus Fund program, expectations regarding how our cash requirements will be met, and expectations regarding the impacts of Bill 20 and IFRS. 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, limitations of vessel repair facilities, 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 except as may be required by applicable law.