# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of the consolidated financial condition and results of operations of British Columbia Ferry Services Inc. should be read in conjunction with Management's Discussion and Analysis presented in our 2004 Annual Report and the consolidated financial statements and accompanying notes for the three months ended June 30, 2004. This discussion and analysis has been prepared as of August 5th, 2004. Additional information relating to our Company is available on SEDAR at www.sedar.com.

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

## Overview

We are one of the largest ferry operators in the world. In the first quarter of 2004/05, we provided over 40,000 sailings, carrying over 5.5 million passengers and 2.1 million vehicles, utilizing 35 vessels.

The consolidated operating revenues and net earnings for the three months ended June 30, 2004 were $140.4 million and $12.3 million, respectively. At June 30, 2004, capital assets were primarily comprised of vessels and terminals, with a net book value of $568.4 million.

We receive service fees pursuant to the Coastal Ferry Services Contract from the Province of British Columbia. In exchange for these fees, we provide agreed ferry service levels on specified routes and administer certain social policy initiatives on behalf of the Province.

Pursuant to a contract between the federal and provincial governments, the federal government provides a subsidy to support the provision of ferry, coastal freight and passenger services in the waters of British Columbia. This subsidy is paid to the Province of British Columbia who then remits it to us under the terms of the Coastal Ferry Services Contract. The amount of the subsidy is adjusted annually based on the Vancouver Consumer Price Index.

Deas Pacific Marine ("DPM"), a wholly owned subsidiary, operates a refit and maintenance facility in Richmond, British Columbia. The company commenced operations on July 1, 2003. DPM provides services to BC Ferries as well as to third parties.

In summary, compared with the first quarter of 2003/04, revenues for this quarter increased by $6.8 million (5%) primarily due to increased toll and retail revenues. Operating expenses increased $7.4 million and interest expense was lower by $0.6 million. The primary factors driving changes in operations expense are labour and fuel costs. Maintenance expense increases reflect our ongoing commitment to safety as well as the requirements of an aging fleet.

Because of the seasonality of leisure travel patterns, we typically generate higher net earnings in the spring and summer period , which are subsequently offset by net losses in the remainder of the fiscal year. In addition, when traffic is lower, we undertake mandatory inspection and maintenance work on the majority of vessels. This results in higher refit and repair expenditures in these periods.

The following table sets forth selected consolidated financial information for our first quarter for the years indicated.

| | Quarter ended June 30, 2004 | 2003 |
|---|---|---|
| | (in thousands) | |
| **Revenue:** | | |
| Tolls | $ 86,588 | $ 81,426 |
| Ferry service fees | 26,649 | 26,396 |
| Federal-Provincial Subsidy Agreement | 6,086 | 5,994 |
| Retail | 16,650 | 15,468 |
| Other income | 4,442 | 4,368 |
| Total Revenue | 140,415 | 133,652 |
| **Expenses:** | | |
| Operations | 67,512 | 64,619 |
| Maintenance | 21,235 | 18,144 |
| Administration | 16,959 | 16,334 |
| Cost of retail goods sold | 6,544 | 5,740 |
| Amortization | 10,858 | 10,876 |
| Total expenses | 123,108 | 115,713 |
| **Earnings from operations** | 17,307 | 17,939 |
| Gain on foreign exchange | 88 | 79 |
| Interest expense | (5,099) | (5,698) |
| Gain on disposal of capital assets | - | 9 |
| **Net earnings** | $ 12,296 | $ 12,329 |

## Results of Operations

***Three Months Ended June 30, 2004 Compared to Three Months Ended June 30, 2003***

*Net Earnings*

For the first quarter of 2004/05, net earnings were $12.3 million, comparable to the net earnings for the first quarter of 2003/04. This resulted from the following:

| | ($ millions) |
|---|---|
| Higher toll revenue | 5.2 |
| Increase in ferry service fees | 0.2 |
| Increase in federal-provincial subsidy | 0.1 |
| Higher revenues from retail sales | 1.2 |
| Higher revenues from other segments | 0.1 |
| Higher operating costs | (2.9) |
| Higher maintenance costs | (3.1) |
| Higher administration expenses | (0.6) |
| Higher cost of retail goods sold | (0.8) |
| Lower interest expense | 0.6 |
| Change in net earnings | 0.0 |

*Higher Toll Revenue*

Toll revenue in the first quarter of 2004/05 was $5.2 million higher than the first quarter of 2003/04. Increased traffic on the majority of routes accounted for a $2.6 million increase while the balance was attributable to tariff increases implemented on January 7, 2004 (increases of 2.8% on the three routes connecting Vancouver Island to the mainland and an average increase of 4.4% on the remaining routes).

*Ferry Service Fees*

Ferry service fees of $26.6 million were received for the first quarter of 2004/05, $0.2 million higher than the first quarter of 2003/04 due to an increase of 5.7% in social program fees. Social program fees (subsidies for seniors, students, disabled and medical assistance traffic) are higher because of the January, 2004 toll increase as well as higher usage. Basic transportation service fees are linked to the number of scheduled sailings which, except for emergency events, are essentially the same each year. The service fee per sailing is fixed over the first performance term of the Coastal Ferry Services Contract, which ends March 31, 2008.

*Increase in Federal-Provincial Subsidy*

The subsidy received in the first quarter of 2004/05 was $6.1 million, a $0.1 million increase from the first quarter of 2003/04. The amount of the annual subsidy increased 1.5% reflecting the increase in the Vancouver Consumer Price Index.

*Higher Revenues from Retail Sales*

Food and retail revenue for the first quarter of 2004/05 increased $1.2 million (7.6%) over the first quarter of 2003/04. Food sales were up 3.1%, the majority of the increase reflects a January 7, 2004 price increase of 3%. Retail spending was up 13.4%, mainly attributable to gift shop expansions on the Queen of Coquitlam and the Spirit of Vancouver Island.

*Higher Costs Related to Operations*

Operating costs include items such as salaries and benefits, fuel, materials, supplies, contracted services, property taxes and insurance. Our operating costs increased by $2.9 million in the first quarter of 2004/05 as compared to the first quarter of 2003/04 as a result of the following increases totalling $4.1 million:

- $1.6 million in property taxes resulting from our change to an assessment based taxation method;
- $0.6 million in commissions and credit card fees;
- $0.5 million in wages due to increased sailings, changes in crew profiles and required overtime;
- $0.4 million in terminal renewal activities;
- $0.3 million in insurance costs; and
- other smaller items totalling $0.7 million.

These increases were offset by a decrease in fuel costs of $1.2 million primarily as a result of hedging contracts entered into in 2003 when the price of fuel was much lower, partially offset by higher prices of unhedged fuel this year. In the first quarter of 2004/05, we incurred fuel expenses of $12.6 million. Fuel costs would have been $14.5 million ($1.9 million greater) without the effect of the hedging contracts.

*Higher Costs Related to Maintenance*

The cost of vessel and terminal maintenance increased $3.1 million to $21.2 million in the first quarter of 2004/05 compared with the first quarter of 2003/04. The major drivers were:

- extraordinary maintenance required for gearbox repair on the Queen of Prince Rupert ($1.2 million);
- the Spirit of British Columbia refit was undertaken in the first quarter of 2004/05 rather than in the last quarter of 2003/04 when normally scheduled, due to labour issues at DPM ($2.0 million); and
- increases in refit costs due to additional requirements from Transport Canada.

*Higher Costs Related to Administrative Expenses*

Administrative expenses increased $0.6 million. The majority of this increase was due to the administrative costs of DPM which was not in operation as a stand alone subsidiary in the previous year.

*Higher Cost of Retail Goods Sold*

The cost of retail goods sold increased $0.8 million as a result of our increased sales. Gross profit decreased by 2% because of price increases in meat and dairy products and the higher cost of branded products.

*Lower Interest Expense*

Interest expense was $0.6 million lower as a result of a lower average interest rate for the quarter (4.59% vs 5.34%). This was mainly due to the lower interest rates payable on the debt instruments issued and in place in this quarter, as described in the Liquidity and Capital Resources section below, compared to the debenture owed to the Province of British Columbia in the previous year.

## Capital Assets

Capital assets increased as capital expenditures for the first quarter of 2004/05 were $26.4 million compared with $10.3 million in the first quarter of 2003/04. Major capital expenditures in the first quarter included:

- the Queen of Cowichan mid-life upgrade ($11.7 million);
- $4.3 million in terminal and building upgrades, and
- $1.6 million in software development.

On April 1, 2003, we received recognition of prepayment of rent under terminal leases concluded with BC Transportation Financing Authority (the "BCTFA") resulting from the transfer of ownership interest in all ferry terminals from the former British Columbia Ferry Corporation to the BCTFA. The leases grant us exclusive access and use of ferry terminal properties for a period of 60 years commencing April 1, 2003. The leases are renewable for an additional period of 20 years at a total cost of $20 per lease if the Coastal Ferry Services Contract is renewed. We must manage, maintain and develop the terminals at our own cost.

## Liquidity and Capital Resources

We fund our operations and growth from cash flow from operations, bank financing and debt issues. We do not view common equity as a potential source of capital and have no present intention of offering equity to the public or other investors.

In May, 2004, we entered into a master trust indenture which establishes common security and a set of common covenants by us for the benefit of our lenders under our financing plan. Our financing plan encompasses an ongoing program capable of accommodating a variety of corporate debt instruments and borrowings ranking *pari passu*.

Under the master trust indenture, we completed an offering of 5.74% Senior Secured Bonds, Series 04-1. Pursuant to our financing plan, the net proceeds from the sale of the Series 04-1 Bonds were used primarily to repay a portion of the indebtedness to the Province of British Columbia and to fund reserves required in connection with the Series 04-1 Bonds. Interest on the Series 04-1 Bonds is payable semi-annually on May 27 and November 27 of each year commencing November 27, 2004 until maturity at May 27, 2014.

We also entered into a credit facility with a syndicate of Canadian banks which is secured under the master trust indenture. Under the credit facility, we were provided with a 364-day revolving operating facility with a one year term-out in an amount up to $77.5 million, a three-year revolving extendible facility in an amount up to $77.5 million and a $200 million two year non-revolving bridge term facility. The revolving term facilities will be available for working capital purposes, to fund the upgrade and acquisition of vessels and terminal upgrades and other general corporate purposes. The bridge term facility was used to repay a portion of the indebtedness to the Province of British Columbia.

At June 30, 2004, we had net cash and cash equivalents of $20.6 million, exclusive of debt service reserves, compared to$17.9 million at March 31, 2004. We are required to maintain a debt service reserve fund for the Series 04-1 bonds and all amounts drawn under the credit facility equal to not less than six months forecasted debt service, to be increased under certain conditions. The debt service reserve fund currently totals $9.8 million and is invested in short-term investments.

Cash provided by operating activities for the first quarter of 2004/05 was $20.5 million compared to $36.5 million in the first quarter of 2003/04. The higher cash generated in the first quarter of 2003/04 resulted from the collection of $17.2 million in respect of the sale of the PacifiCat vessels in March, 2003.

We estimate that cash provided by operating activities will be sufficient to fund approximately half of the capital expenditures over the next decade. The balance will need to be raised in the form of debt from external lenders.

## Critical Accounting Estimates

### *Workers' Compensation Claims Liability*

Our financial statements include an estimate for residual workers' compensation claims liability, arising from the Workers' Compensation Board (the "WCB") deposit class coverage system, in which our predecessor entity participated prior to March 31, 2003.

The WCB provided our predecessor company with an actuarial valuation of the unfinalized claims remaining to be paid out relating to incidents on or prior to March 31, 2003. This estimate is included in the calculation of deferred employee obligations and reflected in our financial statements.

***Employee Service Pension Plan***

Our employees are members of the Public Service Pension Plan (the "Plan''), a defined benefit, multi-employer pension plan.

On April 2, 2003, we were converted into an independent company incorporated under the *Company Act (British Columbia)*. In February 2004, our Company and the BCFMWU jointly submitted a formal application for all of our employees and our Company to remain within the Plan. In March 2004 the Public Service Pension Board of Trustees agreed to continue the Plan for our Company and our employees.

The Plan is exempt from the requirements under the *Pension Benefits Standards Act (British Columbia)* to use the ''solvency'' method in conjunction with the ''going concern'' method for valuation purposes. As such, the Plan is currently valued solely by the going concern method. The most recent valuation of the total plan, as at March 31, 2002, indicated a surplus in the Basic Account of $546 million.

***Other Estimates***

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires our management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from these estimates.

***Future Accounting Changes***

Effective April 1, 2004, we adopted the Canadian Institute of Chartered Accountants ("CICA") Accounting Guideline 13, "Hedging Relationships" and the CICA Handbook Section 3110, "Asset Retirement Obligations". The adoption of these changes did not have a material impact on our financial results. No new future accounting changes are contemplated at this time.