

## **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 2003/04 Annual Report and the consolidated financial statements and accompanying notes for the six months ended September 30, 2004. This discussion and analysis has been prepared as of November 1st, 2004. Additional information relating to our Company is available on SEDAR at [www.sedar.com](http://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 six months ended September 30, 2004, we provided over 86,000 sailings, carrying over 13 million passengers and 4.9 million vehicles, utilizing 35 vessels.

During our second quarter, we entered into a contract with Flensburger Schiffbau-Gesellschaft (FSG) of Germany to build three new major vessels. These new vessels form part of a long-term capital plan to upgrade and revitalize our fleet.

On October 15, 2004, the arbitrator issued an interim award in regard to the collective agreement between the Company and the BC Ferry and Marine Workers' Union (BCFMWU). This agreement will provide us with long-term labour stability and provide a framework for continuous improvement in relations with our union staff.

The consolidated operating revenues and net earnings for the six months ended September 30, 2004 were \$334.8 million and \$75.3 million, respectively. At September 30, 2004, capital assets, primarily comprised of vessels and terminals, had a net book value of \$570.1 million.

We receive service fees from the Province of British Columbia pursuant to the Coastal Ferry Services Contract. 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 maintenance services to us as well as to third parties.

In summary, revenues for the six months ended September 30, 2004 increased \$14.5 million (4.5%) over the same period last year primarily due to increased toll and retail revenues. Operating costs increased \$12.4 million and interest expense was lower by \$1.7 million. The primary factors driving changes in operations costs were increases in labour costs and higher property taxes.

Our reported earnings have not been impacted by the current high prices of fuel oil. Consistent with regulatory practice in other regulated industries, our regulator, the British Columbia Ferry Commissioner, has authorized us to maintain deferral accounts to mitigate the effect on our earnings of unpredictable and uncontrollable price volatility in world fuel oil markets. The Commissioner has established set prices for fuel oil for each of the years until March 31, 2008. Differences between the set prices and the actual prices of fuel oil are held in the deferral accounts. These deferral accounts will be maintained until March 31, 2008, at which time the Commissioner will decide on their continuation. Any balance in the deferral accounts (\$1.2 million at September 30, 2004) will be taken into account by the Commissioner in setting future tolls charged to customers. It is expected that all deferred fuel costs will be recovered through tolls as approved by the Commissioner.

The level of maintenance expense reflects 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 other quarters. 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 the three months and six months ended September 30 for the years indicated.

(\$thousands)	Three Months ended September 30 <sup>th</sup>		Six Months ended September 30 <sup>th</sup>	
	2004	2003	2004	2003
<b>Revenue :</b>				
Tolls	\$126,032	\$119,766	\$212,620	\$201,192
Ferry service fees	30,743	30,593	57,392	56,990
Federal-Provincial Subsidy Agreement	6,086	5,994	12,172	11,988
Retail	24,577	23,224	41,227	38,692
Other Income	6,935	7,098	11,377	11,465
<b>Total Revenue</b>	<b>194,373</b>	<b>186,675</b>	<b>334,788</b>	<b>320,327</b>
<b>Expenses:</b>				
Operations	81,040	78,626	154,780	149,122
Maintenance	13,676	14,293	36,303	33,421
Administration	10,422	9,025	19,761	18,498
Cost of retail goods sold	9,348	8,240	15,892	13,980
Amortization	12,017	11,270	22,875	22,146
<b>Total expenses</b>	<b>126,503</b>	<b>121,454</b>	<b>249,611</b>	<b>237,167</b>
<b>Earnings from operations</b>	<b>67,870</b>	<b>65,221</b>	<b>85,177</b>	<b>83,160</b>
Gain (loss) on foreign exchange	(163)	(13)	(75)	66
Interest expense	(4,715)	(5,801)	(9,814)	(11,499)
Gain on disposal of capital assets	13	900	13	909
<b>Net earnings</b>	<b><u>\$ 63,005</u></b>	<b><u>\$ 60,307</u></b>	<b><u>\$ 75,301</u></b>	<b><u>\$ 72,636</u></b>

## Results of Operations

### *Three and Six Months Ended September 30, 2004 Compared to Three and Six Months Ended September 30, 2003*

#### *Net Earnings*

During the second quarter, our net earnings were \$63.0 million, compared to \$60.3 million for the second quarter of last year. Net earnings for the six months ended September 30, 2004 were \$75.3 million, compared to \$72.6 million for the same period last year. The changes from the comparable three and six month periods last year are summarized below:

	Three Months (\$millions)	Six Months (\$millions)
Net earnings to September 30, 2003	\$60.3	\$72.6
Higher toll revenue	6.3	11.4
Increase in ferry service fees	0.2	0.4
Increase in federal-provincial subsidy	0.1	0.2
Higher revenues from retail sales	1.3	2.5
Lower revenues from other segments	(0.2)	-
Higher operations costs	(2.4)	(5.6)
Lower (higher) maintenance costs	0.6	(2.9)
Higher administrative expenses	(1.4)	(1.3)
Higher cost of retail goods sold	(1.1)	(1.9)
Higher amortization	(0.7)	(0.7)
Lower interest expense	0.9	1.5
Gain on disposal of capital assets	<u>(0.9)</u>	<u>(0.9)</u>
Net earnings to September 30, 2004	<u>\$63.0</u>	<u>\$75.3</u>

#### *Higher Toll Revenue*

*\$6.3 Million Three Months*

*\$11.4 Million Six Months*

Toll revenue in the second quarter was \$6.3 million (\$11.4 million for the six month period) higher than last year. Increased traffic on the majority of routes accounted for an increase of \$1.6 million (\$4.2 million for the six month period) 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).

*Increase in Ferry Service Fees*

*\$0.2 Million Three Months*

*\$0.4 Million Six Months*

Ferry service fees in the second quarter were \$0.2 million (\$0.4 million for the six month period) higher than the previous year due to an increase of 3.3% (4.5% for the six month period) 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*

*\$0.1 Million Three Months*

*\$0.2 Million Six Months*

The subsidy received in the second quarter was \$0.1 million (\$0.2 million for the six month period) higher than the previous year. The amount of the annual subsidy increased 1.5% reflecting the increase in the Vancouver Consumer Price Index.

*Higher Revenues from Retail Sales*

*\$1.3 Million Three Months*

*\$2.5 Million Six Months*

Food and retail revenue for the second quarter increased \$1.3 million or 5.8% (\$2.5 million or 6.5% for the six month period) over the previous year. Food sales for the six months ended September 30, 2004 were up 3.3%, the majority of the increase reflecting a January 7, 2004 price increase of 3%. Retail spending was up 15.1%, mainly attributable to gift shop expansions on the Queen of Coquitlam, Queen of Cowichan and the Spirit of Vancouver Island.

*Higher Operations Costs*

*(\$2.4 Million) Three Months*

*(\$5.6 Million) Six Months*

Operations costs include items such as salaries and benefits, fuel, materials and supplies, contracted services, property taxes and insurance. Our operations costs in the second quarter were \$2.4 million higher (\$5.6 million for the six month period) compared to the previous year as a result of the following:

Increases

- \$1.6 million (\$3.3 million for the six month period) in property taxes resulting from our change to a normal taxation method, consistent with a private company;
- \$0.6 million (\$1.6 million for the six month period) in labour costs to meet additional Transport Canada safety requirements;
- \$0.6 million (\$1.2 million for the six month period) in terminal renewal activities; and
- other smaller items totalling \$0.4 million (\$1.5 million for the six month period).

Decrease

- \$0.8 million in fuel costs for the quarter (\$2.0 million for the six month period) compared to the previous year. In the second quarter this year, we incurred fuel expenses of \$14.6 million (\$27.1 million for the six month period). Fuel expenses for the six month period ended September 30, 2004 would have been \$28.3 million, \$1.2 million higher, without the deferral accounting authorized by the Ferry Commissioner.

*Maintenance Costs*

*\$0.6 Million Three Months (\$2.9 Million) Six Months*

The cost of vessel and terminal maintenance for the second quarter was \$0.6 million lower (\$2.9 million higher for the six month period) compared with the previous year. Maintenance costs are generally higher because of the planned increase in refits and the requirements of Transport Canada. The costs in the second quarter of last year were unusually high due to the costs resulting from a fire on the Queen of Surrey.

*Higher Administrative Expenses*

*(\$1.4 Million) Three Months (\$1.3 Million) Six Months*

Administrative expenses for the second quarter were \$1.4 million (\$1.3 million for the six month period) higher than the previous year due to:

Increases

- \$1.0 million (\$1.6 million for the six month period) in information technology to meet growing business requirements;
- \$0.6 million (\$0.6 million for the six month period) restructuring costs incurred;
- \$0.6 million (\$0.6 million for the six month period) resulting from corporate capital tax reassessments received for years 1998 through 2001; and
- \$0.7 million (\$0.3 million for the six month period) in other smaller items.

Decreases

- \$0.9 million (\$1.2 million for the six month period) in employee benefit costs; and
- \$0.6 million (\$0.6 million for the six month period) recovery of prior years' excise tax paid on fuel used to generate electricity on vessels.

*Higher Cost of Retail Goods Sold*

*(\$1.1 Million) Three Months (\$1.9 Million) Six Months*

The cost of retail goods sold increased \$1.1 million for the quarter (\$1.9 million for the six month period) from the previous year as a result of our increased sales. Gross profit decreased by 2.4% because of price increases in meat and dairy products and the cost of disposable supplies.

*Higher Amortization*

*(\$0.7 Million) Three Months (\$0.7 Million) Six Months*

The increased amortization expense this year reflects the increase in capital assets as described in the Capital Assets section below.

### *Lower Interest Expense*

*\$0.9 Million Three Months*

*\$1.5 Million Six Months*

Interest expense in the second quarter was \$0.9 million (\$1.6 million for the six month period) lower than the previous year as a result of a lower average interest rate for the quarter (4.37% vs. 5.33%) and for the six months ended September 30 (4.67% vs. 5.33%). This was mainly due to the lower interest rates payable on the debt instruments issued and in place this year, as described in the Liquidity and Capital Resources section below, compared to the interest rate on the debenture owed to the Province of British Columbia in the previous year.

### *Gain on Disposal of Capital Assets*

*(\$0.9 Million) Three Months*

*(\$0.9 Million) Six Months*

Compared to the prior year, reported gains on disposal of capital assets have decreased \$0.9 million in both the second quarter and the six months ended September 30. Prior year second quarter results included a gain of \$1 million resulting from the disposal by our subsidiary, Catamaran Ferries International Inc., of the high speed ferry construction facility, its last remaining capital asset.

### **Capital Assets**

Capital assets increased as capital expenditures for the second quarter were \$11.5 million (\$37.9 million for the six month period) compared with the second quarter of the previous year of \$8.5 million (\$18.8 million for the six month period). Major capital expenditures for the six months ended September 30, 2004 include:

- Vessel upgrades and modifications including the Queen of Cowichan mid-life upgrade (\$13.5 million) and the Queen of Prince Rupert renovations (\$6.0 million);
- \$12.3 million in terminal and building upgrades, and
- \$3.5 million in software development

On April 1, 2003, terminal leases were concluded with the BC Transportation Financing Authority. These leases grant us exclusive access and use of ferry terminal properties for a period of 60 years commencing April 1, 2003, and have been fully prepaid for this period. 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.

On September 17, 2004, we entered into a contract with FSG of Germany to build three new major vessels. These contracts, with a total value of €206.4 million Euros or approximately \$325 million Canadian, form part of the total project budget of \$542 million (including Canadian taxes, financing expenses and project management costs). The new vessels, scheduled for delivery in late 2007 through mid 2008, will replace aging vessels which currently provide service on our major routes. These are design-build, fixed price contracts that provide us with substantial guarantees related to delivery dates, performance criteria, cost certainty and quality of construction.

## 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 a \$250 million 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.

In May, 2004, 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, currently undrawn; a three-year revolving extendible facility in an amount up to \$77.5 million, currently undrawn; and a \$200 million two year non-revolving bridge term facility, fully drawn. 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.

On October 13, 2004 we completed a \$250 million offering of 6.25% Senior Secured Bonds, Series 04-4. Pursuant to our financing plan, the net proceeds from the sale of the bonds were used to repay the \$200 million bridge term facility with the balance available for general corporate purposes. Interest on the Series 04-4 Bonds is payable semi-annually on April 13 and October 13 of each year commencing April 13, 2005 until maturity at October 13, 2034.

At September 30, 2004, we had net cash and cash equivalents of \$69.2 million, exclusive of debt service reserves, compared to \$17.9 million at March 31, 2004. We are required to maintain a debt service reserve 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 currently totals \$9.8 million and is invested in short-term investments.

Cash provided by operating activities for the second quarter was \$59.8 million (\$80.3 million for the six month period) compared to \$44.9 million (\$81.4 million for the six month period) in the previous year.

Internal cash flow generation is expected to fund approximately half of the capital expenditures over the next decade, with the balance funded by borrowings.

## **Critical Accounting Estimates**

### ***Workers' Compensation Claims Liability***

Our financial statements include an estimate for residual liability for workers' compensation claims 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 of \$9.3 million is drawn down as claims are finalized. The remaining balance is included in deferred employee obligations 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 did not have a material impact on our financial results. No new future accounting changes are contemplated at this time.