

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

The following is our discussion and analysis of the financial condition and results of operations for British Columbia Ferry Services Inc. as of June 9, 2005. This should be read in conjunction with the consolidated financial statements for the year ended March 31, 2005 (fiscal year 2005).

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

The certifying officers of British Columbia Ferry Services Inc. have concluded that the disclosure controls and procedures as of March 31, 2005 are effective.

Business Overview

British Columbia Ferry Services Inc. is an independent company providing ferry services on the west coast of British Columbia. We operate one of the largest and most complex ferry systems in the world, with 35 vessels operating on 25 routes. We are a versatile company, providing a wide range of ferry services for our customers. In fiscal year 2005, we provided over 183,000 sailings, carrying over 22 million passengers and 8 million vehicles. Passenger and vehicle traffic was 3.1% higher than the previous fiscal year.

Our customers travel on our ferries for business purposes and for leisure. Our traffic volumes are affected by a number of external factors, including population growth, economic trends and the tourism industry.

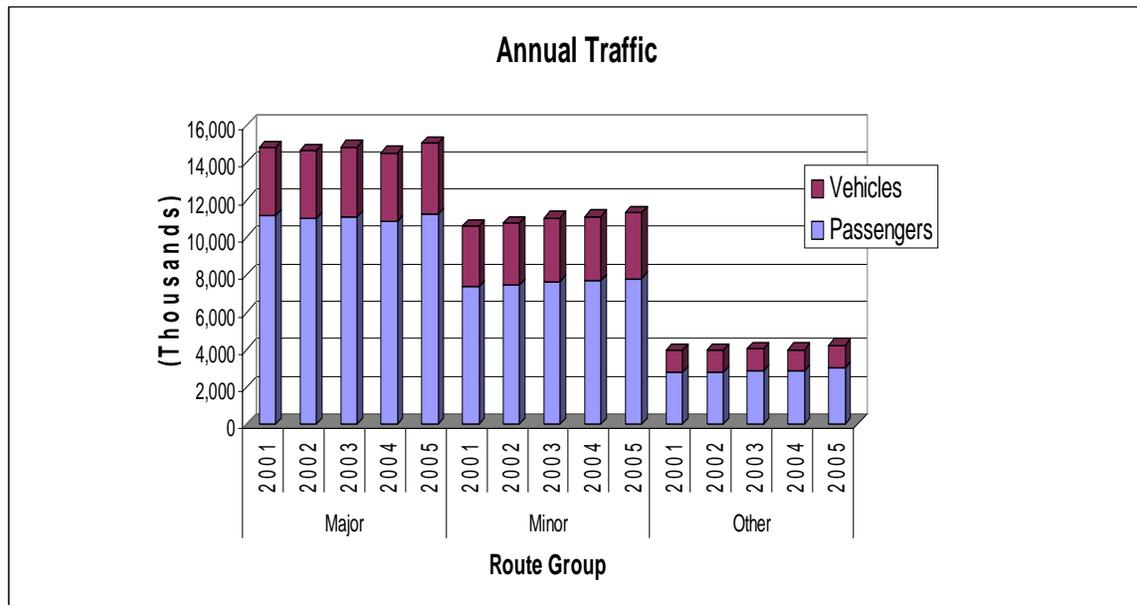
Tourism is on the rebound in British Columbia.¹ We witnessed an increase in bus tours in fiscal year 2005, reflecting a renewed growth in tourism after a period of reduced volume on our major routes due to the 9/11 terrorist attacks in the United States in 2001, and the SARS outbreak the following year. With the announcement of Vancouver as the host city for the 2010 Olympics, the impact on tourism and our business is expected to remain strong and grow.

We placed increased emphasis on travel demand management techniques by offering differential pricing for peak and off-peak travel. We also expanded our service offering by providing more scheduled service. This allowed an increase in the number of reservations year over year, while also increasing availability on sailings for those electing to travel without reservations.

The demand for coastal ferry services has increased, with 4.1 percent growth from 2001 to 2005, or approximately 1% per year. Based upon the above traffic drivers and our use of demand management techniques, this growth is expected to continue.

¹ Chief Economist, The Conference Board of Canada

Quarterly results are affected by the seasonality of leisure travel patterns. The second quarter, covering the summer period, experiences the highest traffic levels and the highest net earnings. The third and fourth quarters reflect a seasonal downturn in traffic. We utilize these periods to perform upgrades and major maintenance and refit programs, as well as to undertake mandatory inspections on the majority of our vessels.



Corporate Structure and Governance

Coastal Ferry Services Contract

We operate ferry services under a regulatory regime as defined by the Coastal Ferry Act, and under the terms set out in the Coastal Ferry Services Contract. This 60-year services contract with the Province of British Columbia (the "Province"), that commenced April 1, 2003, stipulates the minimum number of round trips that must be provided for each regulated ferry service route in exchange for specified fees. These fees are fixed over the first performance term of the contract, which ends March 31, 2008. The Coastal Ferry Services Contract also includes fees for the provision of specific social program services delivered on behalf of the Province.

Under the terms of this contract, we also receive an annual amount from the Province based on its agreement with the Government of Canada to fulfill the obligation of providing ferry services to coastal British Columbia. The amount of this payment is adjusted annually based on the Vancouver Consumer Price Index.

Economic Regulatory Environment

The office of the British Columbia Ferry Commissioner (the "Commissioner") was created under the Coastal Ferry Act, enacted by the Province on April 1, 2003. The Commissioner regulates price caps for designated ferry route groups which, to the end of the first performance term, are specified in the Coastal Ferries Act. The Commissioner is also responsible for regulating the reduction of service, discontinuance of routes and certain other matters. The Coastal Ferry Act requires the Commissioner to undertake regulation in accordance with several principles, including placing priority on the financial sustainability of ferry operators, encouraging ferry operators to adopt a commercial approach to ferry service delivery and moving over time to a greater reliance on a user pay system.

2005 Financial Overview

This section provides an overview of our financial performance over the past 3 fiscal years.

Our consolidated net earnings in fiscal year 2005 grew \$11.8 million or 42.3% from the previous fiscal year. Our earnings in fiscal year 2004, before loss on disposal of high-speed ferries grew \$3.6 million or 14.8% from the fiscal year 2003.

(\$millions)	Year ended March 31		
	2005	2004	2003
Total revenue	564.5	533.7	489.9
% Growth	5.8%	8.9%	3.6%
Expenses	(499.5)	(481.7)	(463.9)
Earnings from operations	65.0	52.0	26.0
Financing & loss on disposal	(25.2)	(24.0)	(1.6)
Earnings before the following	39.8	28.0	24.4
Loss on disposal of high-speed ferries			(53.1)
Net Earnings (Loss)	39.8	28.0	(28.7)
		As at March 31	
	2005	2004	2003
Total assets	763.4	629.8	636.8
Total long-term financial liabilities	516.6	443.3	18.6

Revenue

Our total revenues have increased steadily over the past three years, as shown in the table below. Year to year changes for the past two fiscal years are discussed separately.

Revenue	Year ended March 31		
	2005	2004	2003
Tariff	345.9	323.0	315.6
Ferry services fees	107.0	105.8	0.0
Federal-Provincial subsidy	24.3	24.0	23.4
Retail	67.8	63.2	61.8
Other income	19.5	17.7	14.9
Motor fuel tax subsidy	0.0	0.0	74.2
Total Revenue	<u>564.5</u>	<u>533.7</u>	<u>489.9</u>

Year to Year Comparison of Revenues - Fiscal 2005 vs. Fiscal 2004

The improvement in our tariff revenue is a result of higher traffic volumes, together with annual average rate increases of 2.8% on our three major routes connecting Vancouver Island to the mainland and 4.4% on the remaining routes. These tariff increases are as permitted by the Coastal Ferry Act.

Ferry service fees are higher due to an increase of \$1.1 million (8.9%) in social program fees received from the Provincial Government. These programs include discount fares for BC seniors, students traveling to and from school, and persons traveling under the Medical Travel Assistance Program. Ferry service fees, other than social program fees, are linked to the number of scheduled sailings which, except for emergency events, are essentially the same each year. Social program fees are based on usage.

The Federal-Provincial subsidy is adjusted each year in accordance with changes in the Vancouver Consumer Price Index.

Retail revenue includes food and other retail merchandise sales. Revenue from food sales grew 2.6% over the previous fiscal year, the majority of the increase reflecting a January 7, 2004 price increase of 3%. Other retail spending increased 13.4%. This increase was mainly attributable to positive customer response to our gift shop expansions on the *Queen of Coquitlam*, *Queen of Cowichan*, and the *Spirit of Vancouver Island*.

The increase in other income reflects increased usage of our reservation system. Reservation fees were \$2.3 million higher than the previous fiscal year, with \$1.9 million more revenue from reservations on our major routes and the balance from the Horseshoe Bay-Langdale route. This increase is partially offset by reductions in foreign exchange and advertising revenues.

Year to Year Comparison of Revenues - Fiscal 2004 vs. Fiscal 2003

Tariff revenue increases in fiscal year 2004, compared to the previous fiscal year, were due mainly to the annual tariff increase. Traffic volume on the major routes lagged behind prior fiscal year results, reflecting the impact of the war in Iraq and the outbreak of SARS on the B.C. tourism sector. We experienced reductions in travel on these routes of 1.2% for vehicles and 2.5% for passengers. These reductions were not as severe as the impact on the B.C. tourism sector as a whole. Traffic volume on our minor and other routes was not significantly affected.

Fiscal year 2004 was the first year of ferry services fees and the first year without the motor fuel tax subsidy, as a result of the Coastal Ferry Services Contract coming into effect April 1, 2003.

Average per passenger spending increased by 3.5% while gross profit per passenger on food and other retail merchandise increased by 1.6% over the previous fiscal year. This resulted in an increase in our retail revenues of \$1.4 million.

Other income was \$2.8 million higher. This change was largely driven by increases in reservation usage on major routes and on the Horseshoe Bay-Langdale route. Reservations first became available on the Horseshoe Bay-Langdale route in July 2003.

Expenses

Expenses for the past three years are summarized in the table below.

Expenses (\$millions)	Year ended March 31		
	2005	2004	2003
Operations	294.0	286.0	
Maintenance	86.8	86.1	
Administration	44.5	38.9	
Total operations, maintenance & administration	425.3	411.0	397.8
% Increase	3.5%	3.3%	3.4%
Cost of retail goods sold	26.5	23.3	22.0
Amortization	47.7	47.4	44.1
	499.5	481.7	463.9
% Increase	3.7%	3.8%	2.3%
Loss (Gain) on foreign exchange	0.1	(0.2)	(0.2)
Interest expense	24.5	22.7	1.4
Loss on disposal of capital assets	0.6	1.6	0.4
	25.2	24.1	1.6

In December, 2003, we changed our income statement format to disclose operations, maintenance and administration expenses. We restated our March 31, 2004 year-end expenses and the expense variance of fiscal year 2005 to fiscal year 2004 will be explained following this classification.

Fuel Deferral

Because of the implementation of an Order from our regulator, the British Columbia Ferry Commissioner, our expenses and reported earnings were not impacted by the high prices of fuel oil in fiscal year 2005. This order authorized us to maintain deferral accounts to mitigate the effect on our earnings of unpredictable and uncontrollable price volatility in world fuel oil markets. This is consistent with regulatory practice in other regulated industries.

In his Order, the Commissioner 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 these deferral accounts. These accounts will be maintained until March 31, 2008, at which time the Commissioner will decide on their continuation. Any balance in the deferral accounts as at March 31, 2008 will be taken into account by the Commissioner in setting future tariffs charged to our customers. It is expected that all such deferred fuel oil costs will be recovered through tariffs as approved by the Commissioner. The balance in the deferral accounts at March 31, 2005 is \$8 million.

The Order recognizes that the existence of the fuel deferral account does not remove our ability to make application under Section 42 of the Coastal Ferry Act for an extraordinary price cap increase because of an increase in the price of fuel oil. If such application is made, and approved by the Commissioner, proceeds from the extraordinary price cap increase will be credited against the balance in the deferral accounts. Because of the persisting high price of fuel, we will be filing such an application.

Year to Year Comparison of Expenses - Fiscal 2005 vs. Fiscal 2004

The total increase in operations expenses was \$8.0 million. The most significant item was an increase of \$5.8 million in property taxes due to 2005 being the first complete calendar year of the change from paying grants in lieu of taxes to property taxes based on assessed value. Another \$1.6 million was due to increased wage and training costs.

Maintenance expenses which include expenditures for vessel refit and maintenance as well as terminal maintenance activities were \$0.7 million higher mainly due to changes in scope and scheduling of vessel refits and maintenance.

Administration expenses increased \$5.6 million. The most significant increase was the cost of corporate information technology support of \$4.3 million. We have had many new initiatives and upgrades in our computer systems which require increased support.

The increased cost of retail goods sold reflects the higher level of retail sales. The expansion of our vessel gift shops with increased lines of merchandise has been very successful.

Amortization increased a total of \$0.3 million. This change was a combination of revisions to the estimates of vessel salvage value and increases from additional assets coming into service offset by the *Queen of Chilliwack* which was fully amortized at the end of March 2004.

Interest expenses increased a total of \$1.8 million reflecting the overall increase in our level of debt and the effect of interest rates payable on the debt instruments issued and in place as described in the "Liquidity and Capital Resources" section below.

Year to Year Comparison of Expenses - Fiscal 2004 vs. Fiscal 2003

The total increase in expenses in fiscal year 2004 was \$13.2 million. In April 2003, we converted from a Crown corporation to an independent company. Because of this, we started paying GST on our direct purchases. Ferry service is an exempt transportation service, therefore, input tax credits cannot be claimed on purchases related to the exempt service. This caused an increase in expenses of \$8.5 million in fiscal year 2004.

We also experienced a \$4.7 million increase in unexpected repairs and maintenance in fiscal year 2004, the most significant of which was as a result of a fire on the *Queen of Surrey* with repairs totalling \$2.9 million.

The \$1.3 million increase in cost of retail goods sold was caused by the higher volume of sales than the previous fiscal year, and the \$3.3 million increase in amortization was driven by the reduction in the useful lives of assets to be replaced by expected vessel and terminal improvement projects.

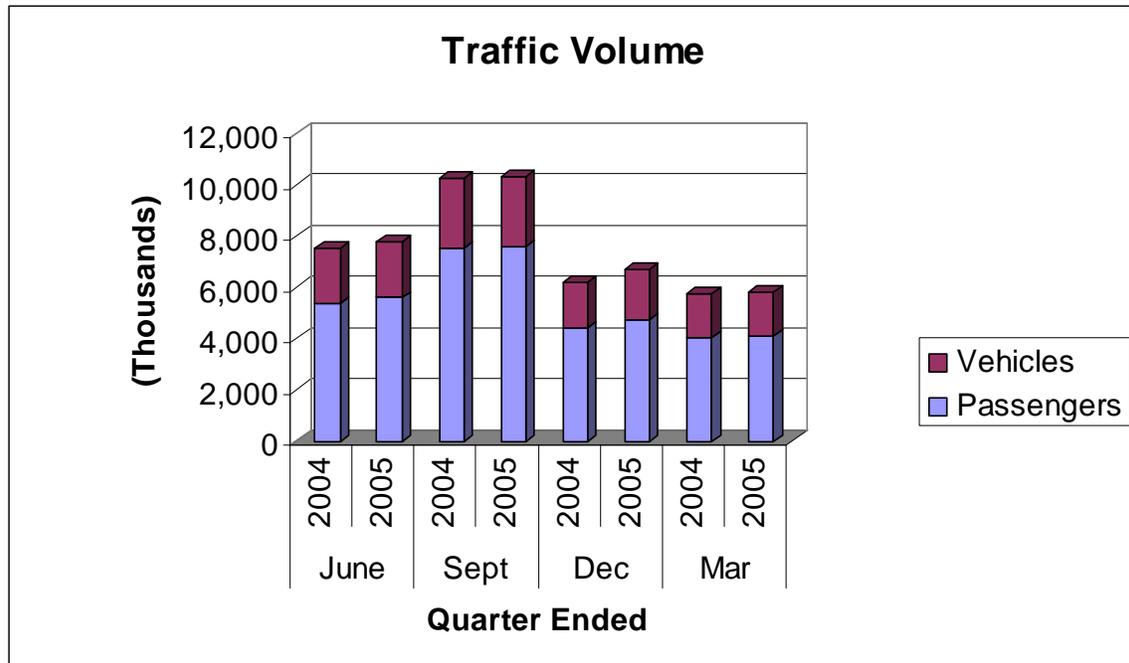
Quarterly Results and Review of Fourth-Quarter Performance

The table below compares earnings by quarter for the fiscal year ended March 31, 2005 and the previous fiscal year.

\$Millions	Quarter ended (Unaudited)				Fiscal 2005
	30-Jun	30-Sep	31-Dec	31-Mar	
Total revenue	140.4	194.4	122.7	107.0	564.5
Earnings (loss) from operations	17.3	67.9	3.6	(23.8)	65.0
Net earnings (loss)	12.3	63.0	(4.2)	(31.3)	39.8

\$Millions	Quarter ended (Unaudited)				Fiscal 2004
	30-Jun	30-Sep	31-Dec	31-Mar	
Total revenue	133.7	186.7	110.2	103.1	533.7
Earnings (loss) from operations	17.9	65.2	(0.8)	(30.3)	52.0
Net earnings (loss)	12.3	60.3	(8.2)	(36.4)	28.0

Our net earnings in each quarter of fiscal year 2005 were equal to or greater than the previous fiscal year. The most significant contributing factor to the trend was higher tariff revenue as a result of increases in both traffic and tariffs. As mentioned above, we increased tariff rates an average of 2.8% on the three major routes and 4.4% on the remaining routes. In addition, traffic increased over the previous year in every quarter, ranging from 0.4% in the second quarter to 8.6% in the third quarter, with an average annual increase of 3.1%.



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.

Highlights of our fiscal year 2005 fourth quarter include:

- Increase in vehicle traffic of 26,700, (1.6%) and in passenger traffic of 69,700 (1.7%) over last fiscal year's fourth quarter.
- One of our flagships, the *Spirit of British Columbia*, returned to service following a major two-and-a-half month refit and passenger-service upgrade. The passenger-service improvements are part of a major initiative to revitalize our fleet, and when combined with the refit expenditures totalled an investment of \$15.2 million. In addition to the numerous customer-service improvements, upgrades have also been made to the vessel's lifesaving equipment.
- Continuation of the *Queen of Oak Bay* mid life upgrade and passenger improvement project. This extensive, six-month upgrade will prepare the vessel for another 20 years of service. It is scheduled to return to service in June 2005. See "Investing in our Capital Assets" below for more detail.

Liquidity and Capital Resources

We fund our operations and capital acquisitions with cash flow generated from operations, as well as bank financing and debt issues. We expect operating cash flows to fund approximately one half of the capital expenditures over the next decade, with the balance funded by borrowings.

Long-Term Debt

In May 2004 we entered into a master trust indenture. This indenture establishes common security and a set of common covenants by us for the benefit of our lenders. Our financing plan encompasses an ongoing program capable of accommodating a variety of corporate debt instruments and borrowings ranking *pari passu*. We do not currently view common share equity as a potential source of capital and have no present intention of offering common shares to the public or other investors.

Under this indenture, we completed a \$250 million public offering of 5.74% Senior Secured Bonds, Series 04-1, due May 27, 2014. The net proceeds were used primarily to repay a portion of our \$427.7 million indebtedness to the Province and to fund reserves required in connection with these bonds. Interest on these bonds is payable semi-annually on May 27 and November 27 of each year until maturity.

We also entered into a credit facility with a syndicate of Canadian banks which is secured under the indenture. Under the credit facility, we were provided with a 364-day revolving operating facility with a one year term-out, in an amount of \$77.5 million, a three-year revolving extendible facility in an amount of \$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 and are currently undrawn. The bridge term facility was fully drawn to repay the remaining portion of our indebtedness to the Province.

In October, 2004 we completed a \$250 million public offering of 6.25% Senior Secured Bonds, Series 04-4, due October 13, 2034. The net proceeds from the sale of these bonds were used to repay the \$200 million bridge term facility and for general corporate purposes. Interest on these bonds is payable semi-annually on April 13 and October 13 of each year until maturity.

Terminal Leases

We entered into a master agreement with the British Columbia Transportation Financing Authority ("BCTFA") effective March 31, 2003, as part of the restructuring of our Company. In return for the transfer of ownership interest in all ferry terminals from the former British Columbia Ferry Corporation to the BCTFA at the time of the corporate restructuring, we received recognition of prepayment of rent under terminal leases.

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.

In fiscal year 2005, we added a total of \$3.9 million of additional lands at Horseshoe Bay and Swartz Bay to the existing terminal leases in exchange for highway improvements.

If we fail to meet our obligations under the terminal leases or default under the Coastal Ferry Services Contract, the BCTFA may at its option re-enter and take possession of the ferry terminal properties and at its option terminate the leases. The BCTFA has entered into an acknowledgement agreement with the Bondholders' Trustee which sets out certain limitations of the use of this option.

Other Long-Term Liabilities

Other long-term liabilities consist primarily of accrued post-retirement and post-employment benefits.

Sources & Uses of Cash

Increases in cash and cash equivalents for fiscal 2005 and 2004 are summarized in the table below.

(\$millions)	Year ended March 31	
	2005	2004
Cash provided by operating activities	102.1	69.5
Cash provided by (used in) financing activities	43.7	(24.4)
Cash used in investing activities	<u>(122.2)</u>	<u>(41.7)</u>
Total increase in cash	<u>23.6</u>	<u>3.4</u>

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

Cash provided by operating activities increased in fiscal year 2005 by \$32.6 million or 46.9%. Working capital requirements were down by \$30.4 million, primarily due to accrued interest on bond issuances which are payable semi-annually with payments made in April and May, 2005; accrued payables on vessel refits and upgrades in progress, and increases in accrued employee time banks.

Cash provided by financing activities during the fiscal year 2005 was \$43.7 million, an increase of \$68.1 million over the previous fiscal year. This was mainly due to the proceeds from our two bond issuances generating more cash than required to repay the debt owed to the Province.

Cash used in investing activities increased by \$80.5 million in fiscal year 2005. This increase was mainly due to higher capital expenditures in fiscal year 2005 and higher proceeds from asset disposals in the previous fiscal year. The significant capital transactions this year are described below in "Investing in our Capital Assets".

Investing in our Capital Assets

Capital expenditures this fiscal year totalled \$127.1 million, funded \$119.8 million through cash and \$7.3 million through non-cash working capital. This level of expenditure reflects significant investments in our fleet, terminals and information systems to increase customer service and operating efficiency. Expenditures in fiscal year 2005 included:

- Vessel upgrades and modifications including \$13.3 million of a \$33.0 million mid-life upgrade to the *Queen of Cowichan*, \$23.0 million of a \$35.4 million mid-life upgrade on the *Queen of Oak Bay*, \$10.9 million for passenger improvements on the *Spirit of British Columbia*, and \$5.4 million for renovations on the *Queen of Prince Rupert*;
- \$18.5 million for preliminary costs for the "Super C" Class vessel construction;
- \$18.7 million in terminal and building upgrades;
- \$18.5 million in marine structures of which \$11.9 is a replacement at Tsawwassen;
- \$13.5 million in software development which will enhance customer service improvements in areas such as reservations and retail and food services, as well as operational efficiencies in crew scheduling.

Major vessel upgrades

The *Queen of Oak Bay*, which provides service on our Nanaimo-Horseshoe Bay route, is undergoing an extensive, six-month upgrade at the Vancouver Drydock Company in North Vancouver (which is a part of the Seaspan International Inc. family of companies and an affiliate of the Washington Marine Group). The contract with Vancouver Drydock, which also includes regular annual refit work, is valued at approximately \$33 million. The 23 year-old vessel, which is scheduled to be back in service in June 2005, will undergo a mechanical and passenger service upgrade to prepare it for another 20 years of service. The upgrades will include improved and expanded passenger amenities, as well as safety and mechanical improvements. The *Queen of Oak Bay* is the third of five "C" Class vessels identified for a mid-life upgrade. The *Queen of Cowichan* completed its mid-life upgrade in May, 2004 and the *Queen of Coquitlam* in June, 2003.

"Super C" Class new vessel construction

On September 17, 2004 we entered into contracts with Flensburger Schiffbau-Gesellschaft ("FSG") to build three new major vessels. These contracts, with a total value of €206.4 million or approximately \$325 million, form the majority of the total project budget of \$542 million. 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. An initial payment of \$16.3 million was made to FSG upon execution of the contracts. All foreign currency based payments in this project have been fully hedged in Canadian dollars, and we expect this project to be completed on schedule and within budget.

Intermediate sized vessel

On October 15, 2004, we issued a Request for Proposal to three shipyards short listed for the construction of a new, intermediate-sized vessel that will facilitate the retirement of the 44 year-old *Queen of Tsawwassen*. Of the 14 shipyards that were invited to participate in a prequalification process, Allied Shipbuilders Ltd. (Canada), Vancouver Shipyards Co. Ltd., and Remontowa S.A. (Poland) were short listed. We currently anticipate that a contract will be negotiated in the summer of 2005, enabling the delivery of a new intermediate vessel by December, 2007.

Tsawwassen Quay

The construction of a new 16,000 square foot retail building is underway at our largest terminal. This building will replace the former food services and retail area and washroom facilities at our Tsawwassen Terminal. The major objective of this 'market-style' facility, scheduled for completion by the summer of 2005, is to enhance the experience of our customers with an expanded selection of food and retail services.

Tsawwassen Terminal Marine Structures

In fiscal year 2005, we completed \$12.0 million of a total budget of \$17.4 million for betterments at our Tsawwassen Terminal. This project includes replacing marine and vehicle ramp structures, constructing a new foot passenger waiting lounge, tower and access walkway as well as upgrading the electrical service. The project is expected to be completed in July 2005.

Technology

Many information and technology enhancements were made in fiscal year 2005.

A "Current Conditions" area was added on our website providing customers with up-to-the minute information on sailings on all of our major routes. This included:

- webcam images of traffic in and around each terminal;
- number of sailing waits (if any) for cars and oversize vehicles;
- deck space committed aboard each vessel;
- direct link to make a reservation;
- parking capacity, actual departure times, terminal conditions, customer information notices and route maps.

Other customer related improvements included:

- a sign on Highway 17, the only direct access road to the Swartz Bay terminal, providing information on current sailings;
- enhanced Integrated Voice Response system and reporting;
- enhanced security for boarding passes; and
- other customer conveniences such as plasma television screens on the Spirit of British Columbia.

Crew scheduling software was implemented, replacing a complex paper-based process.

New Occupational Health and Safety ("OSH") software was introduced that helps manage Workers Compensation Board claims and related administration costs and ensures compliance with new federal legislation

A corporate incident tracking and management system was implemented to consolidate the various types of information related to an incident. This includes links to OSH, incident claims reporting, safety and audit.

A new catering revenue collection and warehouse system was also implemented which provides enhanced features of recipe management and food and beverage warehousing.

We also implemented new software for employee and manager self-service. This system allows employees to update their personnel information and assists them in their career development. Employees can also access training via the web, and file for personal expenses on-line.

Risk Management

We have processes in place throughout our company to manage risks that inevitably arise in the normal course of business.

We are implementing an Enterprise Risk Management program which will address risk management from an organization-wide perspective and will complement existing strengths. This will be a comprehensive approach that incorporates organization-wide awareness, prioritized risk identification and risk mitigation strategies that target the highest risk areas.

Understanding and managing risk are important parts of our business. The following are some of the risk factors that we have considered.

Safety

The safety of the public, our employees and the protection of the environment are our highest priorities.

We are regulated by the provincial Workers' Compensation Board and Transport Canada to ensure adequate safety on our vessels and at our other facilities. In addition, we have initiated new programs to ensure a high standard of employee safety.

As well, we were an early voluntary adopter of the International Safety Management ("ISM") code that forms an international standard for the safe management and operation of ships and terminals and for pollution prevention. The ISM code places the responsibility for the safety of ships and the prevention of pollution within the company management structure. This means that the entire organization is responsible for safety, not just the ship's master or shore based managers.

Environmental Risk

Our operations are subject to various environmental laws and regulations dealing with the transportation, storage, presence, use, disposal and handling of hazardous materials and hazardous wastes, discharge of storm water and vessel fuel delivery.

If we were to be involved in an environmental accident or be found in material violation of applicable law and regulations, we could be responsible for material clean-up costs, property damage, and fines or other penalties, any of which could have a material adverse effect. Although we believe we maintain adequate environmental insurance, there can be no guarantee that the insurance coverage will be sufficient to cover all such losses.

Traffic Level and Tariff Revenue Risk

Future vehicle and passenger traffic on our vessels will be affected by, among other things, population levels and economic conditions in British Columbia and also by tariff rates. No assurance can be given as to the level of traffic on our system and the tariff revenue that will result.

There is a risk that over the long term a general decline in travel (or a reduction in the growth rate) may occur as a result of compounding increases in tariffs. Under the Coastal Ferry Act, we are permitted to increase tariffs on major routes by 2.8% and on the remaining routes by 4.4% each year during the first performance term. In addition to these permitted annual increases, we may apply to the Commissioner for other tariff increases, the need for which results from extraordinary situations. To date, the price increases we have implemented have not caused an obvious decrease in demand. However, elasticity could change as prices increase, thereby resulting in an increasing negative impact of tariff increases.

A relatively high percentage of our customers travel for leisure purposes - approximately 77% on major routes; 82% on northern routes and 63% for other routes. Traffic on our vessels may decline, or fail to increase as expected, if world or local events have a negative affect on tourism.

Competition

While there are significant barriers to entry, we face the risk of competitors entering the vehicle and passenger ferry market and potentially eroding our market share. This risk is greater on the most profitable routes, potentially from other ferry service providers in addition to other forms of transportation.

Asset Risk

We operate in a capital-intensive industry that requires a substantial amount of capital expenditures. We plan to spend approximately \$1.9 billion in capital expenditures over the next decade, with approximately 70% related to new vessel acquisitions, vessel upgrades and component replacement. Our plan is to replace approximately 25% of our vessels before the end of the 2010/11 fiscal year.

At March 31, 2005, we have a total indebtedness of \$500 million. Future indebtedness is subject to certain limitations. The level of indebtedness could increase our vulnerability to general adverse economic and industry conditions, and limit our flexibility in planning for, or reacting to, changes in business. Also, there can be no guarantee that we will have access to sufficient resources or will be able to maintain our fleet by extending the economic life of existing vessels through major refurbishment.

Accident/Casualty Loss

The occurrence of a vessel related accident or mishap could have a material adverse effect on our business prospects, financial condition or results of operations, and could result in a default under the Coastal Ferry Services Contract unless such accident or mishap qualified as an event of force majeure.

Due to the nature of our business, we may be subject to liability claims arising out of accidents or disasters involving vessels on which our customers are traveling, including claims for serious personal injury or death.

Apart from well established safety programs, we have an insurance program to insure both our physical assets and legal liability for injuries and damage. This is designed to mitigate the financial impact of serious incidents. There can be no guarantee, however, that the insurance coverage will be sufficient to cover all such accidents or disasters.

In addition to conventional insurance, we have recently established our own wholly owned insurance subsidiary, BCF Captive Insurance Company Ltd., which commenced operations April 1, 2005. Its prime purpose is to absorb a large proportion of the deductibles payable under our commercial insurance programs. The objective is to spread the cost of random events among all routes, and protect direct route financial results from unnecessary volatility.

Seismic Risk

Our facilities and operations are located in an area that is subject to seismic activity. There is a risk that a seismic incident of significant magnitude may occur and have an adverse impact on our operations. We carry insurance which covers property damage resulting from such incidents; however, we do not carry business interruption insurance.

Tax Risk

Our company has received an advance income tax ruling from CRA that, provided the facts and other statements set out therein are accurate, we are a "Tax Exempt Corporation" described in paragraph 149(1)(d.1) of the Income Tax Act. This ruling is subject to a proposed amendment to subsection 149(1.3) of the Income Tax Act announced by the Department of Finance on December 20, 2002, the essential elements of which are now included in a February 27, 2004 release from the Department of Finance of draft amendments to the Tax Act. We have received a non-binding opinion from CRA that proposes subsection 149(1.3), if amended as proposed on December 20, 2002, will not cause us to cease to be a Tax Exempt Corporation. There can be no assurance that subsection 149(1.3) of the Income Tax Act will be amended as proposed, or that we are and will continue to be a Tax Exempt Corporation.

Regulatory Risk

There is a risk that the Commissioner will interpret the Coastal Ferry Act in a manner which could have an adverse financial impact on us.

Our operations are subject to a wide variety of national and local laws and regulations, all of which may change at any time. There is the potential that the introduction of new safety or other regulations, including new taxes, or the interpretation of existing regulations, may impose a new, unexpected and significant cost burden. There can be no guarantee that regulatory changes in the future will not have an adverse effect on us.

Labour Disruption Risk

Our service is an integral part of British Columbia's coastal transportation system, and has been designated by the Province as an essential service for purposes of the provincial Labour Relations Code. This designation means our services are considered necessary for the protection of the health, safety and welfare of the residents of BC.

The majority of our employees are members of the B.C. Ferry and Marine Workers' Union. On October 15, 2004, an interim award was issued by an arbitrator, affecting the terms and conditions of employment for bargaining unit employees. This is a seven-year award, which we expect will provide us with labour stability over that period. There can be no guarantee that other labour disturbances won't occur and have a material adverse effect on our operations.

Risk of Default Under Material Contracts

There is a risk that we will default under the Coastal Ferry Services Contract or the Terminal Leases. The consequences of such default could include, among other things, an adjustment to service fees from the Province or the forced sale of our vessels to the Province for net book value and termination of the Terminal Leases.

Aboriginal Land Claims

Canadian courts have recognized that aboriginal peoples may possess rights at law in respect of land used or occupied by their ancestors where treaties have not been concluded to deal with these rights and where treaties between Aboriginal peoples and the Crown set out express rights. These rights may vary from limited rights of use for traditional purposes to a right of aboriginal title and will depend upon, among other things, the nature and extent of the prior aboriginal use and occupation of lands. The courts have encouraged the Canadian federal and provincial governments and aboriginal peoples to resolve rights claims through the negotiation of treaties.

Aboriginal groups have claimed substantial portions of land in British Columbia over which they claim aboriginal title or in which they have a traditional interest and for which they are seeking compensation from various levels of government.

A process is now in place within British Columbia to deal with aboriginal land claims. These negotiations have been and will likely remain ongoing for a number of years, depending on the commitment of the parties involved and the precedents set by the outcomes of the first settlement agreements. Under evolving jurisprudence, Canadian governments may have a duty to consult and accommodate Aboriginal peoples where Crown approvals or licences are required in respect of existing or new terminal facilities or operations at such facilities.

Under the Master Agreement, the Province retains its liability, to the extent any exists, for the acts and omissions of the Province that occurred prior to our possession of the ferry terminal properties leased under the Terminal Leases, and will reimburse us for any damages we suffer as a result.

In addition, the Province will reimburse us for damages suffered if there is a final court decision or a treaty settlement that recognizes or confers upon a First Nation a proprietary or other interest in the ferry terminal properties and that right or interest interferes with our quiet enjoyment of the ferry terminal properties as set out in the Terminal leases.

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 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.

We believe the following are the most critical accounting policies and estimates that we have used in the preparation of our financial statements.

Workers' Compensation Claims Liability

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

The WCB provided our predecessor company with an actuarial valuation of the unfinalized claims remaining to be paid that relate to incidents on or prior to March 31, 2003. This estimate totalled \$9.3 million at March 31, 2003 and is drawn down as claims are paid out. The remaining balance at March 31, 2005 of \$6.5 million (\$6.9 million at March 31, 2004) is included in deferred employee obligations in our financial statements.

Public Service Pension Plan

Our employees are members of the Public Service Pension Plan (the "Plan"), a defined benefit, multi-employer pension plan. In April 2003, we were converted from a Crown corporation into an independent company incorporated under the provincial Company Act. In February 2004, our company and the union representing our employees jointly submitted a formal application for all our employees and our company to remain within the Plan. In March 2004, the Public Service Pension Board of Trustees agreed to the proposal.

The Plan is exempt from the requirements under the provincial Pension Benefits Standards Act 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 available to us indicated a surplus in the Basic Account of \$546 million as at March 31, 2002.

Retirement Bonus Liability

We sponsor a plan that provides a post-retirement benefit for long service employees. The valuation of this plan is estimated based on complex actuarial calculations using several assumptions. These assumptions are determined by management with significant input from our actuary. The valuation of the obligation depends on such assumptions as discount rate, projected salary increases, retirement age and termination rates. An actuarial valuation was obtained in March, 2005 and the accrued benefit obligation estimated at \$10 million. The liability included in deferred employee obligations in our financial statements at March 31, 2005 was \$9.5 million (\$9.4 million at March 31, 2004).

We have adopted the corridor method of recognizing actuarial gains and losses. Any gains and losses in excess of 10% of the obligation balance will be amortized over the average remaining service period of employees expected to receive benefits under this plan.

Rate Regulation

We follow generally accepted accounting principles which, as we are a regulated entity, may differ from those otherwise expected in non-regulated businesses. These differences occur when the regulator renders decisions and generally involve the timing of revenue and expense recognition to ensure that the actions of the regulator, which create assets and liabilities, have been reflected in the financial statements.

The accounting for these items is based on an expectation of the future actions of the regulator. As of March 31, 2005, we have deferred the difference between amounts included in tariffs for fuel costs and those actually incurred based on the expectation that our regulator will approve the recovery or refund of the deferred balance in future tariffs.

If the regulator's future actions are different from our expectations, the timing and amount of the recovery of deferred fuel costs could be substantially different from that reflected in the financial statements.

Amortization Expense

Our capital assets, including assets under capital leases, are amortized on a straight-line basis at varying rates. Amortization rates require the use of estimates of the useful lives of the assets and of salvage to be realized upon asset retirement.

We periodically review asset lives in conjunction with our longer term asset deployment, replacement and upgrade strategies. When we determine that asset lives do not reflect the expected remaining period of benefit, we make prospective changes to the remaining period over which they are amortized. There are a number of uncertainties inherent in estimating our asset lives and changes in these assumptions could result in material adjustments to our financial statements.

As disclosed in note 1 to our financial statements, we review and evaluate our long-lived assets for impairment when events or changes in circumstances indicate that the related amounts may not be recoverable.

Hedging Relationships

On April 1, 2004, we adopted the Canadian Institute of Chartered Accountants (CICA) Accounting Guideline 13, with revisions, relating to hedging relationships. The Guideline addresses the identification, designation, documentation and effectiveness of hedging transactions for the purpose of applying hedge accounting. It also identifies situations where hedge accounting is to be discontinued. Under this guideline, we are required to document and demonstrate that our hedges are sufficiently effective in order to continue accrual accounting for positions hedged with derivatives. We have met the criteria for all designated hedging relationships and adoption of this guideline did not impact our financial statements.

Asset Retirement Obligations

On April 1, 2004, we adopted the CICA new standard for recognition, measurement and disclosure of liabilities for asset retirement obligations and the associated asset retirement costs. Under the new standard the fair value of a liability for an asset retirement obligation must be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The fair value is added to the carrying amount of the associated asset, which is then expensed over the asset's estimated useful life. The liability is accreted over the estimated useful life of the asset through charges to expenses.

As we are not aware of any future liabilities associated with the retirement of our assets, the adoption of this policy does not result in the recording of an asset retirement liability and therefore our financial statements have not been impacted by this new standard. In addition, as our operations are regulated, there is a reasonable expectation that any significant asset retirement costs would be recoverable through future tariffs.

Audit and Finance Committee

Our Audit and Finance Committee (the "Committee") is appointed by the Board of Directors to assist the Board in fulfilling its oversight responsibilities. The Committee has the mandate to:

- Review the financial reports and other financial information provided by the Company to its security holders
- Review the annual operating and capital budgets, modifications thereto, and details of any proposed financing
- Monitor the integrity of the financial reporting process and the system of internal controls that the Board and our management have established
- Monitor the management of the principal risks that could impact the financial reporting of the Company, and the Company's compliance with legal and regulatory requirements as they relate to the Company's financial statements
- Review and approve the audit plan, process, results, and performance of the Company's external auditors and the internal audit department ("the internal auditor") while providing an open avenue of communication between the Board, management, external auditors, and the internal auditor
- Assess the qualifications and independence of the external auditors, and recommend to the Board the nominations of the external auditors and the compensation to be paid to the external auditors.

The Committee has the authority to conduct any investigation appropriate to fulfilling its responsibilities, and it has direct access to the external auditors as well as anyone in the organization. The Committee has the authority to retain special legal, accounting, and other advisors or experts it deems necessary in the performance of its duties.

Committee membership as at March 31, 2005 was as follows: Graham M. Wilson, Chair; Douglas E. Allen; Sandy M. Fulton; John R. Henderson; and Maureen V. Macarenko. As of April 1, 2005, Thomas W. Harris replaced Sandy M. Fulton on the committee.

Each of the members of the Audit and Finance Committee have been determined by the Board of Directors to be independent, that is, without any direct or indirect relationship with the Company that could reasonably interfere with the exercise of the member's independent judgement. Douglas E. Allen acted as interim Chief Executive Officer of the Company from October 16, 2002 until May 5, 2003.

All members of this Committee are financially literate within the meaning of Multilateral Instrument 52-110, that is, each has the ability to read and understand a set of financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of the issues that can reasonably be expected to be raised by the Company's financial statements.

Since April 1, 2004, all recommendations of the Audit and Finance Committee to nominate or compensate an external auditor were adopted by the Board.

The aggregate fees billed by our external auditor in each of the last two fiscal years were:

External Auditor Billings (\$thousands)	Year ended March 31	
	2005	2004
Audit (including involvement in bond prospectus)	189.2	99.8
Tax services (mainly commodity related)	12.7	17.4
All other fees		
Advisory services (mainly employee related)	1.7	6.8
Risk assessment (CHaRTS software project)	0.0	49.4
	<u>203.6</u>	<u>173.4</u>

Pursuant to its terms of reference, the Audit and Finance Committee must pre-approve the retaining of the external auditors for any non-audit service to be provided to the Company or its subsidiaries, provided that no approval shall be provided for any service that is prohibited under the rules of the Canadian Public Accountability Board or the Public Company Accounting Oversight Board, or the Independence Standards of the Canadian Institute of Chartered Accountants.

Before the retaining of the external auditors for any non-audit service, the Committee must consider the compatibility of the service with the external auditors' independence. The Committee may pre-approve the retaining of the external auditors for the engagement of any non-audit services by establishing policies and procedures to be followed prior to the appointment of the external auditors for the provision of such services. To date no such policies and procedures have been established. In addition, the Committee may delegate to one or more members the authority to pre-approve the retaining of the external auditors for any non-audit services to the extent permitted by applicable law.

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 BC Ferries' growth, results of operations, performance, business prospects and opportunities and industry performance and trends. They reflect management's current internal projections, expectations or beliefs and are based on information currently available to management.

In some cases, forward looking statements can be identified by terminology such as "may", "will", "should", "expect", "plan", "anticipate", "believe", "estimate", "predict", "potential", "continue" or the negative of these terms or other comparable terminology. A number of factors could cause actual events or results to differ materially from the results discussed in the forward looking statements. In evaluating these statements, prospective investors should specifically consider various factors, including, but not limited to, the risks and uncertainties associated with traffic volume and tariff revenue risk, the impact of competition, asset risk, accident/casualty loss risk, tax risk, environmental risk, regulatory risk, labour disruption risk, risk of default under material contracts and aboriginal land claims.

Actual results may differ materially from any forward looking statement. Although management believes that the forward looking statements contained in this management's discussion and analysis are based upon reasonable assumptions, investors cannot be assured that actual results will be consistent with these forward looking statements. These forward looking statements are made as of the date of this management's discussion and analysis, and British Columbia Ferry Services Inc. assumes no obligation to update or revise them to reflect new events or circumstances.