Management's Discussion and Analysis
of Financial Condition and Results of Operations
For the three and nine months ended December 31, 2005
Dated February 6, 2006

The following is our discussion and analysis of the financial condition and results of operations for British Columbia Ferry Services Inc. as of February 6, 2006. This should be read in conjunction with our unaudited interim consolidated financial statements and related notes for the three and nine-month periods ended December 31, 2005 and 2004, and our annual audited consolidated financial statements and related notes together with our fiscal 2005 Management's Discussion and Analysis. These documents are available on the SEDAR web site at www.sedar.com.

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 a wide range of ferry and ancillary 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. 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 B.C.

Our quarterly results are affected by the seasonality of leisure travel patterns. The second quarter, covering the summer period, experiences the highest traffic levels and the highest earnings. The third and fourth quarters reflect a seasonal downturn in traffic. We utilize these periods to perform upgrades and major maintenance and refit programs as well as to undertake mandatory inspections on the majority of our vessels. Our maintenance and upgrade program is currently well underway. During the fiscal year ending March 31, 2006, 28 of our 35 vessels will undergo refit. During the three months ended December 31, 2005, we provided over 46,000 sailings, carrying 4.6 million passengers and 1.9 million vehicles. Vehicle traffic was 2.5% lower, while passenger traffic was 2.7% lower, than for the three months ended December 31, 2004. We believe that reduced levels of tourism were a factor in this decline.

Significant events during or subsequent to the three months ended December 31, 2005, include the following:

- Fuel costs continue to exceed prices built into previous rate schedules. As at December 31, 2005, the balance in our fuel deferral accounts to be recovered was $20.6 million. On January 20, 2006, the British Columbia Ferries Commissioner issued an order to grant a further price cap increase to allow us to implement an additional fuel surcharge of 1.5% for major routes and 3% for most other routes, effective February 1, 2006. In the event of continuing high fuel costs, the Commissioner's order provides a potential for further price cap increases effective June 2006. Based on our current experience and estimates, we expect to see additional price cap increases. The Commissioner has developed a formula to determine the amount, if any, of the increase. In addition, the Commissioner has set for us a fuel conservation target of reducing fuel consumption by 1% in fiscal 2007 and by an additional 1% in fiscal 2008. See "Financial Overview—Expenses" for more details.

- On October 13, 2005, we entered into loan agreements for up to $180 million with the German Export Bank, KfW, to finance the purchase of two “Super C-class” vessels. The funds will be drawn upon the conditional acceptance of the vessels. The term of these loans is twelve years.
- On November 1, 2005, (October 1, 2005 on the Northern routes) we increased our fares. The *Coastal Ferry Act* permits average fare increases of 2.8% on the three major routes connecting Vancouver Island to the Lower Mainland and 4.4% on the remaining routes.
- The *Queen of Surrey*, which provides service on our Horseshoe Bay to Langdale route, was removed from service on November 16, 2005, for an extensive mid-life upgrade, including safety, structural and mechanical improvements. This extensive upgrade will prepare it for another 20 years of service. See “Investing in Our Capital Assets” for more details.
- The *MV Kwuna*, which provides service on our Skidegate to Alliford Bay route, returned to service on December 20, following the completion of a major refit to upgrade systems to increase fuel efficiency and provide greater durability and reliability. See “Investing in Our Capital Assets” for more details.
- During the three months ended December 31, 2005, we entered into a conditional letter of intent with Vancouver Shipyards of the Washington Marine Group for the construction of a new 125-car ferry to replace the 45 year-old *Queen of Tsawwassen* which letter of intent subsequently expired. We are currently evaluating technical design changes proposed by Vancouver Shipyards, and performance test results. See “Investing in Our Capital Assets” for more details.
- While we will maintain responsibility for the long-term delivery of ferry services, under the *Coastal Ferry Act* we are required to test the market to determine if another operator, under contract to us, can provide a more cost-effective service offering. The expressions of interest we received in the second quarter in response to our request to identify parties interested in providing ferry service on our northern routes have been evaluated. We have also completed our evaluation of the expression of interest we received for the operation of our Brentwood Bay to Mill Bay route on Vancouver Island. The expressions of interest received justify moving to future phases of the process.
- On January 3, 2006, the *Spirit of Vancouver Island*, which provides service on our Tsawwassen to Swartz Bay route, was removed from service for its annual refit and passenger services upgrade. The refit includes overhauling two of the four engines, repainting the vessel and a complete renovation of all interior passenger areas which is part of a major initiative to revitalize the fleet. See “Investing in Our Capital Assets” for more detail.
- The *Queen of Nanaimo*, which provides service on our southern Gulf Islands routes, returned to service on January 14, 2006 following the completion of a refurbishment totalling approximately $16 million. The vessel, built in 1964, underwent upgrades to lifesaving equipment and structural fire protection and improvements to passenger accommodations. See “Investing in Our Capital Assets” for more details.
- On January 19, 2006, the Property Assessment Appeal Board accepted an agreement we reached with BC Assessment Authority to settle our 2004 and 2005 terminal property assessment appeals. The settlement reduces our terminal property assessments by approximately 40% for 2004 and 47% for 2005. See “Financial Overview—Expenses” for more details.

Financial Overview

This section provides an overview of our financial performance for the three months ended December 31, 2005 compared to the three months ended December 31, 2004, as well as the nine months ended December 31, 2005 (year-to-date) compared to the nine months ended December 31, 2004.

Our consolidated net loss for the three months ended December 31, 2005 was a $3.3 million improvement over the net loss for the three months ended December 31, 2004. For the nine months ended December 31, 2005, our net earnings were $3.6 million or 5.1% higher than the same period of the previous year.

	Three Months Ended December 31				Nine Months Ended December 31			
			Variance				Variance	
($ millions)	2005	2004	$	%	2005	2004	$	%
Total revenue	126.0	122.7	3.3	2.7%	469.5	457.6	11.9	2.6%
Expenses	(120.6)	(119.1)	(1.5)	-1.3%	(375.7)	(368.8)	(6.9)	-1.9%
Earnings from operations	5.4	3.6	1.8	50.0%	93.8	88.8	5.0	5.6%
Interest and other	(6.3)	(7.8)	1.5	19.2%	(19.1)	(17.7)	(1.4)	-7.9%
Net earnings (loss)	(0.9)	(4.2)	3.3	78.6%	74.7	71.1	3.6	5.1%

Revenue

Our total revenues for the three months ended December 31, 2005 have increased over the three months ended December 31, 2004 as well as year-to-date, as shown in the following table.

	Three Months Ended December 31				Nine Months Ended December 31			
			Increase				Increase	
($ millions)	2005	2004	$	%	2005	2004	$	%
Tariff – vehicles	47.3	46.6	0.7	1.5%	182.2	177.6	4.6	2.6%
Tariff – passengers	27.3	26.3	1.0	3.8%	110.6	107.9	2.7	2.5%
Ferry service fees	25.4	24.9	0.5	2.0%	83.6	82.3	1.3	1.6%
Federal-provincial subsidy	6.2	6.1	0.1	1.6%	18.7	18.3	0.4	2.2%
Retail	14.7	14.6	0.1	0.7%	56.5	55.9	0.6	1.1%
Other income	5.1	4.2	0.9	21.4%	17.9	15.6	2.3	14.7%
Total revenue	126.0	122.7	3.3	2.7%	469.5	457.6	11.9	2.6%

Comparison of Revenue

The improvement in vehicle tariff revenue in the three months ended December 31, 2005, compared to the three months ended December 31, 2004, is a result of higher tariff rates, partially offset by lower traffic volumes. We increased our rates by an average of 2.8% and 4.4% as permitted by the *Coastal Ferry Act*.

Vehicle Traffic Volume	Three Months Ended December 31			
			Decrease	
	2005	2004	$	%
Major routes	827,320	847,355	(20,035)	-2.4%
Other routes	1,065,144	1,093,403	(28,259)	-2.6%
Total	1,892,464	1,940,758	(48,294)	-2.5%
	Nine Months Ended December 31			
			Decrease	
	2005	2004	$	%
Major routes	3,065,249	3,079,960	(14,711)	-0.5%
Other routes	3,763,148	3,766,735	(3,587)	-0.1%
Total	6,828,397	6,846,695	(18,298)	-0.3%

Vehicle traffic volumes were 2.5% lower for the three months ended December 31, 2005 compared to the three months ended December 31, 2004 (0.3% year-to-date). We believe reduced levels of tourism have contributed to this decline. There was also a change in the mix of type of vehicles carried (fewer semi-trailers and more trucks of a shorter length) which further contributed to a decline in expected revenue. We expect to experience a decline of approximately 7% in vehicle traffic on our major routes in the quarter ended March 31, 2006 compared to the same period in the prior year, primarily due to the timing of Easter.

Passenger Traffic Volume	Three Months Ended December 31			
			Decrease	
	2005	2004	$	%
Major routes	2,328,773	2,382,735	(53,962)	-2.3%
Other routes	2,302,532	2,377,656	(75,124)	-3.2%
Total	4,631,305	4,760,391	(129,086)	-2.7%
	Nine Months Ended December 31			
			Decrease	
	2005	2004	$	%
Major routes	9,104,840	9,239,153	(134,313)	-1.5%
Other routes	8,564,545	8,666,653	(102,108)	-1.2%
Total	17,669,385	17,905,806	(236,421)	-1.3%

Total passenger traffic volume in the three months ended December 31, 2005, decreased by 2.7% from the three months ended December 31, 2004 (1.3% year-to-date). In the three months ended December 31, 2005, compared to the same period in the prior year, the major routes experienced a 2.3% decline while the other routes decreased by 3.2%. As with vehicle traffic volume, we believe that reduced levels of tourism have contributed to this decline. In the three months ended December 31, 2005, total passenger tariff revenue increased by 3.8% (2.5% year-to-date) as a result of tariff rate increases described above. Again, as with vehicle traffic volume, we expect to experience a reduction of approximately 2.8% in passenger traffic on the major routes in the quarter ended March 31, 2006 compared to the same quarter in the prior year. This, again, is primarily a reflection of the timing of Easter.

Ferry service fees were higher in the three months ended December 31, 2005, than in the three months ended December 31, 2004, due to an increase of $0.5 million or 16.0% ($1.3 million or 12.9% year-to-date) in social program fees. These programs include discount fares for B.C. seniors, students travelling to and from school, the disabled 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. We expect that the increased usage of discounted fares through social programs will continue throughout the end of this fiscal year.

The federal-provincial subsidy, which we receive from the Province of British Columbia pursuant to the Coastal Ferry Services Contract, is adjusted each year in accordance with changes in the Consumer Price Index for Vancouver.

Retail revenue includes food and other retail merchandise sales. Increases in average spending per passenger during the three months ended December 31, 2005 as compared with the three months ended December 31, 2004 were partially offset by the effect of the decline in passenger traffic during the same period. For the nine months ended December 31, 2005 compared to the nine months ended December 31, 2004 the increase of $0.6 million is attributable to an increase of 1.5% in food and beverage spending per passenger and an increase of 0.6% in average retail goods spending per passenger. This increase was mainly attributable to positive customer response to our menu development initiatives, and to gift shop expansions on the *Queen of Oak Bay* and the *Spirit of British Columbia.* We are forecasting an increase of 2% in retail revenue this fiscal year over the year ended March 31, 2005, based on the higher average spending per passenger we have been experiencing.

The increase in other income reflects higher usage of our reservation system and an increase in the price of reservations. Reservation revenues were $0.3 million (10.8%) higher in the three months ended December 31, 2005 compared to the three months ended December 31, 2004, ($1.5 million or 16.0% year-to-date). The major routes provided $0.2 million ($1.3 million year-to-date) more revenue from reservations with the balance of the increase from the Horseshoe Bay–Langdale route. We expect to experience a continuation of the increased usage of our reservation system on these routes throughout the balance of this fiscal year.

Expenses

Expenses for the three months ended December 31, 2005 totalled $126.9 million, the same total as for the three months ended December 31, 2004. Expenses for the nine months ended December 31, 2005 were $8.3 million or 2.1% higher than the same period in the prior year, as shown in the following table.

	Three Months Ended December 31				Nine Months Ended December 31			
			(Increase)Decrease				(Increase)Decrease	
($ millions)	2005	2004	$	%	2005	2004	$	%
Operations	69.4	68.4	(1.0)	-1.5%	229.4	223.1	(6.3)	-2.8%
Maintenance	21.8	23.5	1.7	7.2%	53.0	59.9	6.9	11.5%
Administration	10.1	10.2	0.1	1.0%	32.5	30.0	(2.5)	-8.3%
Cost of retail goods sold	6.1	5.8	(0.3)	-5.2%	21.9	21.7	(0.2)	-0.9%
Amortization	13.3	11.2	(2.1)	-18.8%	38.9	34.1	(4.8)	-14.1%
Loss (gain) on foreign exchange	(0.1)	0.2	0.3		(0.2)	0.3	0.5	
Interest expense	6.3	7.2	0.9		19.3	17.1	(2.2)	
Loss on disposal of capital assets	0.0	0.4	0.4		0.0	0.3	0.3	
Total expense	126.9	126.9	(0.0)	0.0%	394.8	386.5	(8.3)	-2.1%

Comparison of Expenses

The total increase in operations expenses from the three months ended December 31, 2004 to the three months ended December 31, 2005 was $1.0 million ($6.3 million year-to-date). The most significant variances were:

- $0.5 million increase ($2.0 million year-to-date) due to property taxes being recorded at actual paid amounts in the nine months ended December 31, 2005 while the prior year-to-date reflected an expectation of a reduction in property taxes related to an appeal of assessed values. See below for an update on this appeal;
- $0.6 million increase ($0.6 million year-to-date) in fuel costs reflecting the increase in set prices, partially offset by lower fuel usage (see below for detail on our fuel deferral);
- $1.3 million year-to-date increase relating to an increase in and the timing of marketing and promotional initiatives; and
- $1.8 million increase year-to-date for costs arising from the *Queen of Oak Bay* incident.[1]

On January 19, 2006, the Property Assessment Appeal Board accepted an agreement we reached with the BC Assessment Authority to settle our 2004 and 2005 terminal property assessment appeals. Prior to becoming an independent company, we paid approximately $1.4 million per year in grants-in-lieu of property taxes. In 2004, we paid $8.9 million in property tax and $9.9 million in 2005. The settlement reduces our terminal property assessments by approximately 40% for 2004 and 47% for 2005 which will result in a one-time reduction of expense in our next quarter of approximately $8.2 million. Repayment options for the refund are being discussed with the municipalities. We are also working with the BC Assessment Authority toward a long-term solution for future property tax assessments.

Maintenance expenses, which include expenditures for vessel refit and maintenance as well as terminal maintenance activities, were $1.7 million lower in the three months ended December 31, 2005 than in the three months ended December 31, 2004 ($6.9 million year-to-date). This reflects extraordinary maintenance expenses we incurred in the prior year. Seasonal downturns in traffic allow us to facilitate an extensive maintenance and upgrade program. During the fiscal year ended March 31, 2006, 28 of our 35 vessels will undergo refit. Investing in our infrastructure to ensure the safety and reliability of our operations continues to be a priority.

Administration expenses were $0.1 million lower in the three months ended December 31, 2005 than the three months ended December 31, 2004 ($2.5 million higher year-to-date). The more significant items contributing to these variances include:

- a planned increase in corporate information technology support of $1.9 million ($3.4 million year-to-date) resulting from the many new initiatives and upgrades in our computer systems;
- a $0.6 million increase ($1.3 million year-to-date) attributable to the implementation of our Internal Control Certification initiative. This initiative arises from changes in securities legislation that require CEO and CFO certification of internal controls over financial reporting;

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[1] On June 30, 2005, the *Queen of Oak Bay* ran aground resulting from a loss of power caused by a mechanical failure of an engine speed control device. No injuries were sustained. Of the earlier reported 28 damaged boats, one claim, that will be covered by insurance, has yet to be resolved. There are no other outstanding claims associated with this incident.

- partially offset by a $1.3 million decrease ($0.7 million year-to-date) in employee wages and benefits.

The increased cost of retail goods sold reflects the higher level of retail sales in the three months ended December 31, 2005 compared to the three months ended December 31, 2004 as well as increased food and beverage costs mainly on the major routes. The total gross margin from retail sales for the nine months ended December 31, 2005, at 61%, is the same as the total gross margin for the same period in the previous year. We expect to end the fiscal year with a gross margin of approximately 61.5%, slightly improved from the previous year's gross margin of 60.9%.

Amortization increased a total of $2.1 million in the three months ended December 31, 2005 from the three months ended December 31, 2004 ($4.8 million year-to-date). This reflects the level of investments during the past 12 months, the most significant being in vessel upgrades and modifications.

Interest expenses in the three months ended December 31, 2005, were a total of $0.9 million lower than the three months ended December 31, 2004 ($2.2 million increase year-to-date). The year-to-date increase in interest expenses reflects our level of debt and higher average interest rates due to the longer term nature of our debt. On October 13, 2004 we completed our second public bond offering of $250 million 6.25% Senior Secured Bonds.

In the three months ended December 31, 2005, our interest expense has been reduced by $0.5 million to reflect the interest rate support we received through the Structured Financing Facility (SFF) Program offered by the Government of Canada for the *Queen of Oak Bay* mid-life upgrade. In the nine months ended December 31, 2005, we have recognized $0.5 million to offset interest costs previously capitalized on the *Queen of Oak Bay* mid-life upgrade and $1.5 million to reduce bond interest costs incurred on our 6.25% Senior Secured Bonds. A total of $4.0 million from the SFF program was placed into trust. Commencing in October 2005, $1.0 million payments are scheduled to be drawn from the trust on each semi-annual bond interest payment date until the funds are exhausted. As other new Canadian built vessels or major vessel refurbishments are planned, we will apply for further support under the Structured Financing Facility Program.

Fuel Deferral and Related Surcharge

In September 2004, the British Columbia Ferries Commissioner issued an order authorizing us to maintain deferred fuel cost accounts to mitigate the effect on our earnings of unpredictable and uncontrollable price volatility in world fuel oil markets. The Commissioner established set prices for fuel oil for each of the years until March 31, 2008, at which time the Commissioner will decide on the continuation of the deferred fuel cost accounts. Differences in fuel costs arising from our actual price paid per litre being higher or lower than the unit set price are charged to deferral accounts.

On June 13, 2005, we filed an application with the British Columbia Ferries Commissioner under section 42 of the *Coastal Ferry Act* for extraordinary price cap increases. We have experienced significantly higher prices for fuel oil than expected. At the time of the application, our annual cost of fuel was projected to be 45% higher than it was two years ago, exceeding $72 million this fiscal year. As a result of the higher forecast costs, the deferred fuel cost account balances would be greater than originally expected. The application requested extraordinary price cap increases to allow for fuel surcharges in order to reduce or eliminate these balances.

The British Columbia Ferries Commissioner's ruling approved extraordinary price cap increases of 4% for major routes connecting Vancouver Island to the mainland and 6% on most other routes. The price cap increases allowed for fuel surcharges which took effect on July 25, 2005 to be applied to all fares. Proceeds from the fuel surcharges are not taken into revenue, but are credited directly against balances in the deferred fuel cost accounts. As at December 31, 2005 the balance in these accounts is $20.6 million.

As part of the Order, the British Columbia Ferries Commissioner also increased the set prices established in a previous ruling by 5% effective July 24th. This change will result in a 5% increase in fuel costs charged to expense for the balance of the current fiscal year and for the two succeeding years. This will reduce the projected amount added to the deferral account balances by an equal amount. The Order can be viewed on the Commissioner's website at www.bcferrycommission.com

As a result of continuing high fuel costs, our annual fuel cost projection is now $76 million this fiscal year. As this would prevent any significant reduction of the deferred fuel cost account balances, we applied to the British Columbia Ferries Commissioner on November 28, 2005, for additional price cap increases to allow for further fuel surcharges.

On January 20, 2006, the Commissioner issued a further decision which was segregated into two parts:

1. The Commissioner granted additional price cap increases which will allow the implementation of an incremental fuel surcharge on all fare types, averaging 1.5% for major routes connecting Vancouver Island and the Mainland and 3% for most other routes, effective February 1, 2006;
2. Another increase may be granted effective June 2006. The Commissioner has developed a formula to determine the amount, if any, of the increase.

In addition, the Commissioner has included a requirement that we develop a plan to address fuel savings and has set an efficiency target requiring us to reduce fuel consumption by 1% in fiscal 2007 and by an additional 1% in fiscal 2008. This Order can also be viewed on the Commissioner's website.

We participate in a fuel hedging program and have entered into commodity fixed price swaps that will fix between 69% and 78% of projected monthly consumption over the balance of the fiscal year commencing in October, 2005. We are also continuing to implement a wide variety of fuel savings measures ranging from operating our vessels to maximum efficiency to installing new, more fuel-efficient engines on some of our vessels. For the nine months ended December 31, 2005, compared to the same period in the previous year, our fuel consumption was reduced by 3.5%. A significant portion of this reduction in fuel consumption is as a result of smaller replacement vessels used on our major routes while our Spirit class vessels were in extensive refit.

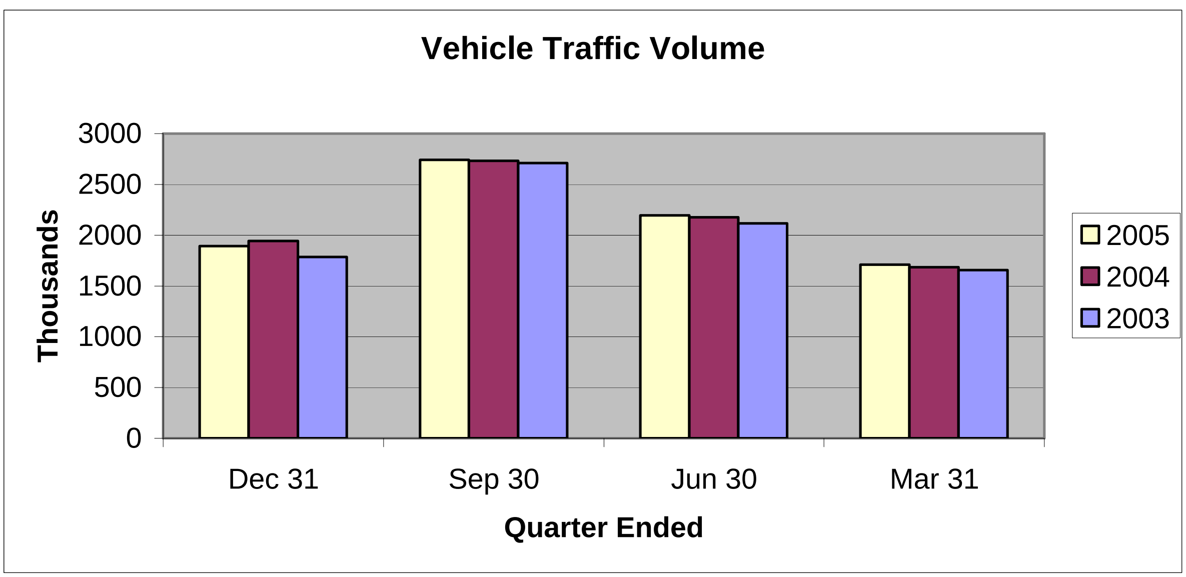
Quarterly Financial Highlights

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

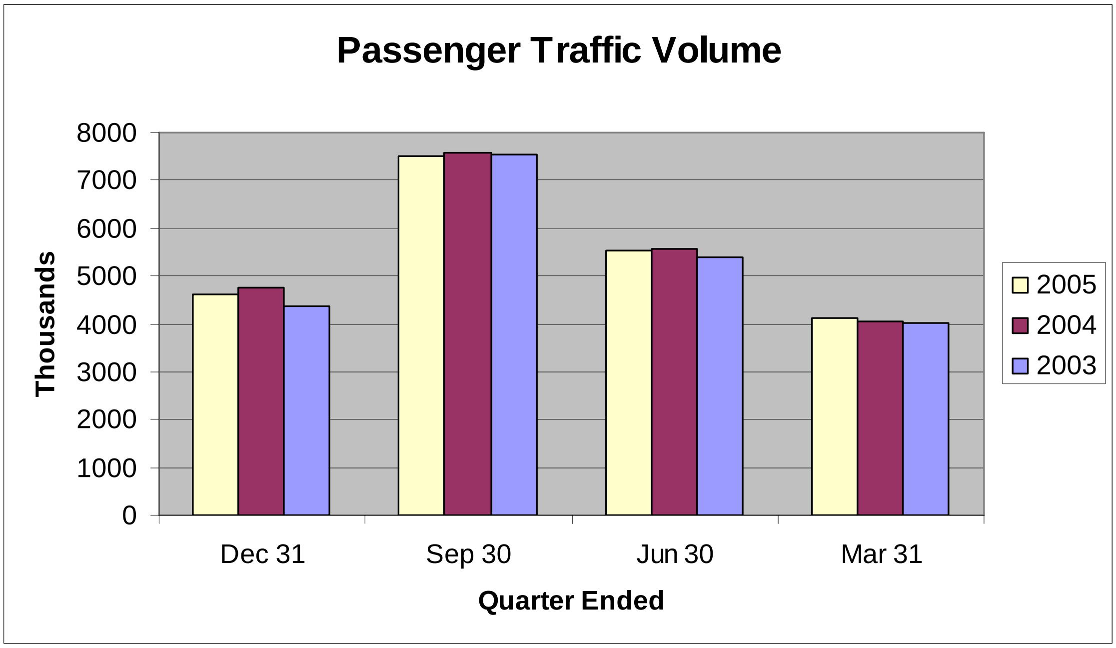
($ millions)	Quarter Ended							
	Dec 05	Sep 05	Jun 05	Mar 05	Dec 04	Sep 04	Jun 04	Mar 04
Total revenue	126.0	198.3	145.2	107.0	122.7	194.4	140.4	103.1
Earnings (loss) from operations	5.4	67.3	21.1	(23.8)	3.6	67.9	17.3	(30.3)
Net earnings (loss)	(0.9)	61.2	14.4	(31.3)	(4.2)	63.0	12.3	(36.4)

Net earnings in the quarters ended December, June and March 2005 were higher than the same quarter in the previous year ranging from $2.1 million to $5.1 million. In the quarter ended September 2005 compared to quarter ended September 2004, net earnings were lower by $1.8 million. The average increase in net earnings for the latest four quarters was $2.2 million.

Total revenue in each of the latest four quarters was higher than the corresponding quarter from the previous fiscal year. The most significant contributing factor to the trend was higher tariff revenue as a result of increases in tariff rates and vehicle traffic. As mentioned above, the *Coastal Ferry Act* permits an annual average tariff increase of 2.8% on the three major routes and 4.4% on the remaining routes. These increases generally take effect in November of each year. Vehicle traffic decreased 2.5% in the most recent quarter compared to the previous year. Vehicle traffic increased over the previous year in every other quarter, ranging from 0.4% in the quarter ended September 30, 2005, to 1.6% in the quarter ended March 31, 2005, with an average four-quarter increase of 1.0%. Despite this generally upward trend, we are experiencing lower than expected traffic levels. We believe this is in part due to reduced levels of tourism. The following graph shows the relationship of the quarters over the past three years.



Passenger traffic in the latest three quarters was lower than the corresponding quarters in the previous year. The average decrease was 1.3% in the three quarters this fiscal year and 0.8% in the last four quarters. We are experiencing lower than expected traffic levels. There has been a reduction this fiscal year in the number of tour buses. We believe the decrease in passenger traffic is also due, in part to reduced levels of tourism. Following is a graph showing the relationship of the quarters over the past three years.



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.

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. Our primary uses of funds are operational expenses, capital asset acquisitions and upgrades, and interest payments on our long-term debt. We expect operating cash flows to fund approximately one-half of the capital expenditures over the next decade, with the balance funded by borrowings.

We have entered into loan agreements which make up to $180 million available to finance our two “Super C” class vessels. These funds will be drawn to coincide with the conditional acceptance dates of the vessels expected in 2008.

We believe that we have sufficient liquidity and capacity to access capital markets in order to maintain operations and fund growth.

Sources and Uses of Cash

Changes in cash and cash equivalents for the three and nine months ended December 31, 2005, and the three and nine months ended December 31, 2004, are summarized in the following table.

($ millions)	Three Months Ended December 31		Nine Months Ended December 31	
	2005	2004	2005	2004
Net income (loss) for the period	(0.9)	(4.2)	74.7	71.1
Items not involving cash:				
Amortization	13.3	11.2	38.9	34.1
Other non-cash charges	0.4	0.5	0.6	0.9
Fuel costs deferred	(4.2)	(3.7)	(12.7)	(4.9)
Change in operating working capital	(3.1)	5.7	(23.4)	(11.3)
Cash provided by operating activities	5.5	9.5	78.1	89.9
Cash provided (used) by financing activities	(0.6)	40.9	(0.6)	49.7
Cash used in investing activities	(37.2)	(39.9)	(84.3)	(77.8)
Total increase (decrease) in cash	(32.3)	10.5	(6.8)	61.8

Cash provided by operating activities was $5.5 million for the three months ended December 31, 2005 ($78.1 million year-to-date). Included in these results was an increase in non cash working capital of $3.1 million ($23.4 million year-to-date). This working capital increase for the three months ended December 31, 2005 was primarily due to:

- a $7.4 million decrease in accrued bond interest payable (semi-annual interest payments made in October and November);
- a $1.1 million increase in inventory levels mainly due to the seasonal increase for parts and supplies relating to vessel maintenance and upgrades;

These increases were partially offset by:

- a $2.6 million decrease in accounts receivable mainly due to timing of receipt of ferry service fees from the provincial government; and
- a $3.0 million decrease in prepaid expenses, due mainly to the expensing of three months of property tax paid in July, 2005.

The $23.4 million increase in non cash working capital for the nine months ended December 31, 2005 was primarily due to:

- a $7.4 million decrease in accrued bond interest payable (semi-annual interest payments made in October and November);
- a $3.7 million increase in accounts receivable mainly due to timing of receipt of ferry service fees from the provincial government;
- an $8.5 million reduction in trade payables and accrued liabilities reflecting the increased spending in the last quarter of fiscal 2005, which was settled in fiscal 2006, payment of construction holdbacks and timing of statutory employee withholdings payments;
- a $1.7 million increase in inventory mainly due to the seasonal increase for parts and supplies relating to vessel maintenance and upgrades and $0.4 million

increase in fuel inventory mainly caused by an average fuel price increase of $0.080 per litre; and

- $1.4 million increase in prepaid expenses relating to the seasonal increase in vessel upgrades and maintenance.

There were $0.6 million costs incurred for financing activities during the three and nine months ended December 31, 2005 for costs relating to the October 13, 2005, $180 million loan agreement with KfW.

Cash used in investing activities was $37.2 million in the three months ended December 31, 2005 ($84.3 million year-to-date). This was due to capital expenditures, on a cash basis, of $27.3 million ($73.3 million year-to-date), $9.9 million for the three and nine months ended December 31, 2005 for the purchase of short-term notes and an increase in lands under long-term lease of $1.1 million year-to-date. The significant capital transactions this year are described below in "Investing in Our Capital Assets".

Investing in Our Capital Assets

Capital expenditures totalled $35.5 million for the three months ended December 31, 2005. The more significant expenditures included:

- Vessel modifications and upgrades including $11.7 million of an estimated $16 million life saving and fire protection upgrade on the *Queen of Nanaimo*; $4.8 million of a projected $38.8 million *Queen of Surrey* mid-life upgrade; $2.9 million of an estimated $4.4 million propulsion system replacement and electrical upgrade on the *MV Kwuna*;
- $9.5 million in marine structures, including $3.7 million at the Swartz Bay terminal and $2.5 million at the Tsawwassen terminal, and
- $2.3 million in software development, mainly for improvements in retail and food services and operational efficiencies such as crew scheduling.

Capital expenditures totalled $75.2 million for the nine months ended December 31, 2005, compared to $75.1 for the same period in the prior year. This level of expenditure reflects significant investments in our fleet, terminals and information systems to improve customer service and operating efficiency. Expenditures in the nine months ended December 31, 2005 included the following:

- Vessel upgrades and modifications including $11.9 million of an estimated $35.1 million mid-life upgrade on the *Queen of Oak Bay;* $14.7 million of an estimated $16 million life saving and fire protection upgrade on the *Queen of Nanaimo;* $4.8 million of a projected $38.8 million mid-life upgrade on the *Queen of Surrey*; $3.6 million of a $4.4 million propulsion system replacement and electrical upgrade on the *MV Kwuna*; $2.6 million of the $500.0 million "Super C–class" vessel project; and $1.2 million on the purchase and transportation of the *MV John Atlantic Burr*;
- $6.6 million in terminal and building upgrades, including a $2.0 million upgrade of passenger facilities at the Horseshoe Bay terminal; $2.2 million towards retail redevelopment at the Tsawwassen terminal; and $1.1 million improvements to the highway approach to the Swartz Bay terminal;
- $20.8 million in marine structures, including $6.7 million at the Tsawwassen terminal, $7.6 million at the Swartz Bay terminal; $1.7 million at Saltery Bay; $1.3 million on Kuper Island; and $1.0 million at the facility of our subsidiary, Deas Pacific Marine; and

- $7.7 million in software development, which will enhance customer service improvements in areas such as reservations and retail and food services, as well as improve operational efficiencies in crew scheduling.

Major Vessel Upgrades

The *Queen of Surrey*, which provides service on our Langdale–Horseshoe Bay route, was removed from service on November 16, 2005, for an extensive $39 million mid-life upgrade. The 25-year-old vessel will undergo significant upgrades to prepare it for another 20 years of service. The upgrades include safety, structural and mechanical improvements as well as improved and expanded passenger amenities. The *Queen of Surrey* is the fourth of five "C–class" vessels identified for a mid-life upgrade. The remaining vessel will be completed in the next fiscal year as part of a major program to renew our fleet and terminals.

The *Queen of Oak Bay*, which provides service on our Nanaimo-Horseshoe Bay route, returned to full service in June 2005, following an extensive mid-life upgrade. The total project cost was $35 million. The 23-year-old vessel underwent significant upgrades to prepare it for another 20 years of service. The upgrades included safety, structural and mechanical improvements as well as improved and expanded passenger amenities. The Queen of Oak Bay is the third of five "C-class" vessels identified for a mid-life upgrade.

The *Spirit of Vancouver Island*, which provides service on one of our major routes, was removed from service January 3, 2006, for its annual refit. The refit includes overhauling two of the four engines, repainting the vessel and a lifesaving equipment upgrade. Passenger service improvements, part of a major initiative to revitalize the fleet, will include an upgraded cafeteria, a redesigned buffet, renovated washrooms, new seating, flooring and carpeting. This project is expected to take two months and total $14 million.

The *Queen of Nanaimo*, which provides service to the Southern Gulf Islands from Vancouver, returned to service on January 14, 2006 following a four month, $16 million refurbishment. This project is expected to add ten years to the life of this vessel. The project included installing a new life-saving system comprised of four marine evacuation slides and rafts; surveying and painting the hull; replacing structural steel; renewing the deck plating; updating structural fire protection; renewing and upgrading boilers; installing a new oily-water separator; and rebuilding the main propeller shafts and controllable pitch propellers. This project also included improvements to customer amenities.

"Super C-Class" vessel construction

Three Super C-class vessels are being built for us under contracts with Flensburger Schiffbau-Gesellschaft ("Flensburger"). These new vessels 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. The general design phase of all systems has been substantively completed and the detailed design or working drawing phase has begun. SmartDesign Group, in Vancouver, has been selected by Flensburger shipyard to develop the interior design standards for the passenger accommodation areas. Lisa Bell & Associates, a Vancouver-based food service facilities consulting firm, has also been contracted by Flensburger to design the equipment layout for all food service areas. Actual construction of the first vessel is expected to begin in September 2006 with delivery by December 2007. This project is currently on-time and on-budget.

New Intermediate Class Ferry

On July 20, 2005, the British Columbia Ferries Commissioner issued a declaration that a new intermediate-class ferry to replace the 45-year-old *Queen of Tsawwassen* is reasonably required. During the three months ended December 31, 2005, we entered into a conditional letter of intent with Vancouver Shipyards of the Washington Marine Group for the construction of a new 125-car ferry which letter of intent subsequently expired. Vancouver Shipyards has recently proposed a number of changes to the design and operational procedures of the proposed vessel. Simulation tests to demonstrate the characteristics of the vessel have recently been completed. We are evaluating the test results and the proposed changes to the design and operational procedures.

MV John Atlantic Burr

In August 2005, we acquired a ferry from the State of Utah for $200,000 (US) through a competitive bid process. This vessel, the *MV John Atlantic Burr*, is similar in design to our three “K-class” vessels, the *MV Kahloke,* the *MV Klitsa* and the *MV Kwuna*. It was designed in Victoria in 1985 and was substantially upgraded with its hull and superstructure lengthened in 1996. The vessel was disassembled in Utah and trucked and barged in pieces to Vancouver. It will require reassembly and significant modifications this winter to upgrade it to our standards and the requirements of Transport Canada.

Tsawwassen Quay

In June 2005, the new $7 million, 16,000-square-foot retail building opened at Tsawwassen, our largest terminal. Tsawwassen Quay offers 18 food, beverage, service and retail outlets. In addition, there are new washroom facilities, bank machines, pay telephones, seven indoor mobile retail kiosks and four outdoor kiosks featuring seasonal crafts and gifts. The Tsawwassen terminal, on average, serves over 4 million passengers each year. The retail facility is managed by Lonsdale Quay Market Corp. under a 10-year lease agreement. This strategic partnership is an example of our long-term business strategy that we are pursuing.

Tsawwassen Terminal Marine Structures

In the nine months ended December 31, 2005, we spent $7 million ($26 million total) upgrading 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. This project is expected to be completed by the end of this fiscal year.

Information Technology

In June 2005, we launched our new stored value card on our major routes. The “Coast Card” is a plastic card with a magnetic strip, similar to a bank card. Assured loading tickets are the first product to be offered on the card. In the future, prepaid tickets and other services will be available through this card. Our Coast Card introduces online account management features so customers can review travel activity, purchase new assured loading tickets and take advantage of other services including loss protection and automatic purchase or renewal options.

We have undertaken a new project to improve communications technology services, replace obsolete technology, reduce costs and manage growth as our business demands change. This project is expected to improve ship-to-shore data communications and provide a more stable, secure and faster network for internal business needs and for our customers. This $4 million project is expected to be complete by the end of this fiscal year.

We are implementing a new catering and retail system that will improve efficiency and reduce costs. This system is replacing a manual inventory system and will provide additional information and improved controls. As a result, we will have better management of our food inventory and will be able to reduce waste. This $5.3 million project is expected to be completed by the end of this fiscal year.

To meet the increased need for enhanced public and employee security, we introduced a new Employee Photo Identification program. The new cards have multi-function technology which will increase access control points on terminals and vessels and allow for the expansion to other applications.

Looking Forward

As discussed above, we expect to experience an overall decline in traffic volumes this fiscal year compared to the prior year. However, we anticipate a modest growth in traffic during the next three years, due to a strong provincial economic forecast and a turnaround in tourism trends reflecting the upcoming Olympic Games. Also, as a result of tariff rate increases, we anticipate higher total tariff revenues. We anticipate a decrease in total expenses in the fourth quarter of the current fiscal year as a result of our favourable property tax settlement of $8.2 million, referred to above. We anticipate that this one-time gain will allow us to accelerate our maintenance and refit program.

Although we have one of the largest fleets in the world, the average age of our assets is currently among the oldest of major ferry operators worldwide. To address this we have initiated a fleet and asset renewal program, and expect to spend more than $900 million over the next three years to upgrade and replace our aging assets. While we are upgrading and replacing a large share of our fleet through new vessel acquisitions and our revitalization program, we continue with an aggressive and proactive maintenance program.

Ferry traffic levels are affected by a number of factors including high fuel costs, a strong Canadian dollar, the public's concerns regarding security, disposable personal income, the local economy and population growth. While we are forecasting modest traffic volume increases over the next few years, we do see opportunities for growth in our markets. We receive over 30 million page views on our website annually. With the increasing use of the internet by travellers planning and booking trips, we are presented with an ongoing opportunity to maximize the role of our website as not only an information source, but also a sales point and distribution channel. We have identified a market development opportunity with the growth in the volumes of commercial semi-trailer and container traffic. Container traffic to Vancouver Island is expected to expand as overseas container movements to the Vancouver Gateway increase and large "big box" retailers continue to locate on Vancouver Island.

Transport Canada regulates safety on our vessels by authority of the *Canada Shipping Act*. It is expected that a revised Act will be implemented in the near future and will include more stringent regulations. Given the age of our fleet, these revised regulations may significantly affect the useful life of some of our vessels, or drive the requirement for upgrades. We are addressing this changing regulatory environment through our planning processes and asset renewal initiatives. As always, the safety and security of our customers and employees remain priority one.

New competitors have emerged in both the passenger only market as well as the commercial traffic market in the past few years. We expect competition may increase in these markets with the potential emergence of private sector vehicle and passenger ferry services. We remain mindful of these potential changes in the market, and we are constantly seeking ways to improve operational efficiency and customer service. We are also exploring opportunities with additional or alternate service providers, in an effort to reduce costs and provide services on our regulated routes, as mandated by the *Coastal Ferry Act*.

Derivative Instruments

We hedge our exposure to fluctuations in fuel prices and foreign currency exchange rates through the use of derivative instruments. The table below indicates the change in valuation of the derivative instruments for the nine months ended December 31, 2005.

($ millions)	December 31, 2005				March 31, 2005	
	Number of swaps	Term to maturity (years)	Carrying Value ($ millions)	Fair Value ($ millions)	Carrying Value ($ millions)	Fair Value ($ millions)
Commodity Fixed Price Swaps	5	Up to 0.5	0.0	0.5	0.0	0.0
Foreign Exchange Forward Transactions	26	Up to 2.5	0.0	(47.3)	0.0	(2.7)

The fair value of the commodity derivatives reflect only the value of the commodity derivatives themselves and not the offsetting change in value of the underlying future purchases of fuel. These fair values reflect the estimated amounts that we would receive or pay to terminate the contracts at the stated dates. Any gains or losses related to fuel commodity swaps are charged to our deferred fuel cost accounts. The foreign exchange derivative value reflects only the value of the foreign exchange derivatives and not the offsetting change in value of the underlying future purchase of currency. These fair values reflect the estimated amounts we would receive or pay to terminate the contracts at the stated dates.

We are exposed to credit risk in the event of non-performance by counterparties to derivative instruments. Because we deal with high credit quality institutions in accordance with established credit approval practices, we do not expect any counterparties to fail to meet their obligations.

Risk Management

Understanding and managing risk are important parts of our business. A discussion of enterprise-wide risk management can be found in the risk management section of our fiscal 2005 annual Management's Discussion and Analysis. Our risk profile is substantially unchanged during the nine months ended December 31, 2005.

The safety of the public, our employees and the protection of the environment are our highest priorities. There is a heightened security concern in the transportation industry. We continue to review and enhance our security planning to ensure that security measures are proactive and responsive. We continue to meet or exceed all legislative requirements respecting the security of our vessels and terminals. We are working closely with Transport Canada under the auspices of the Canadian Ferry Operators Association in the development of marine security policies related to domestic ferry operations. We consult regularly with the RCMP, Transport Canada Marine Security and other intelligence agencies, and participate in a provincial critical infrastructure security intelligence and information network.

Accounting Practices

Critical Accounting Policies and Estimates

This 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.

During the second quarter of the current fiscal year, we adopted a new accounting policy, Interest Rate Support. For more information on significant accounting policies, please refer to note 1 of our March 31, 2005, financial statements and note 1 of our December 31, 2005 interim financial statements.

Certain of our 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.

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, seismic 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.