Management's Discussion and Analysis
of Financial Condition and Results of Operations
For the three months ended June 30, 2006
Dated August 4, 2006

The following is our discussion and analysis of the financial condition and results of operations for British Columbia Ferry Services Inc. as of August 4, 2006. This should be read in conjunction with our unaudited interim consolidated financial statements and related notes for the three month periods ended June 30, 2006 and 2005, and our annual audited consolidated financial statements and related notes together with our fiscal 2006 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 ferry services on the west coast of British Columbia. We operate one of the largest and most complex ferry systems in the world, with 34 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 of British Columbia (the "Province") as an essential service for purposes of the provincial Labour Relations Code. This designation means our services are considered necessary for the protection of the health, safety and welfare of the residents of BC.

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.

We are a versatile company, providing a wide range of ferry services for our customers. During the three months ended June 30, 2006 (the first quarter of fiscal 2007), we provided over 46,000 sailings, carrying 5.5 million passengers and 2.2 million vehicles.

Significant events during or subsequent to our first quarter of fiscal 2007:

- In May 2006 we received insurance proceeds of $67.9 million relating to the loss of the *Queen of the North*. In March 2006, while operating on its regular route from Prince Rupert to Port Hardy, the *Queen of the North* ran aground and subsequently sank. We continue to operate the *Queen of Prince Rupert* and, on an interim basis, are augmenting this service with tug and barge and air service.

  An international search is underway to lease or purchase a replacement vessel for the *Queen of the North*. Once we have a new vessel, it will take several months for it to be ready for service. We are in discussions with the Province as to the appropriate level of service to be provided until a replacement vessel is in place. It is uncertain at this time what the impact of this incident will be on related ferry service fees. See “Financial Overview – *Queen of the North*” for more detail.

- The *Queen of Surrey,* which provides service on the Langdale – Horseshoe Bay route, returned to service on June 27, 2006 following an upgrade which included significant mechanical and safety improvements as well as upgraded passenger amenities. This extensive, mid-life upgrade has prepared the vessel for another 20 years of service. See “Investing in our Capital Assets” below for more detail.
- As a result of continuing high fuel costs, an additional fuel surcharge of 3.2% on major routes and 9.6% on most other routes was applied to all fares on June 22, 2006. See “Financial Overview – Expenses” for more details.
- In July 2006, we announced the signing of a $45.5 million contract with Vancouver Shipyards, a Washington Marine Group company, to build a new 125-car intermediate size ferry. Construction on the 100 metre vessel will begin later this year. The new vessel is expected to enter service by the summer of 2008. See “Investing in our Capital Assets” below for more detail.
- In July 2006, we commissioned an independent review of our safety policies, procedures and practices. This comprehensive safety audit is underway and a report is expected to be available in late 2006. It is our intention to carry out a major audit of this nature every five years as part of our ongoing commitment to ensuring the safety of our passengers and employees.

FINANCIAL OVERVIEW

This section provides an overview of our financial performance for the first quarter of fiscal 2007.

Our consolidated net earnings before extraordinary items in the first quarter of fiscal 2007 grew $0.5 million or 3.5% from the three months ended June 30, 2005 (the first quarter of fiscal 2006).

	Three Months Ended June 30			
			Variance	
($millions)	2006	2005	$	%
Total revenue	146.2	145.2	1.0	0.7%
Expenses	(126.0)	(124.1)	(1.9)	(1.5%)
Earnings from operations	20.2	21.1	(0.9)	(4.3%)
Interest and other expenses	(5.3)	(6.7)	1.4	20.9%
Net earnings before extraordinary items	14.9	14.4	0.5	3.5%
Extraordinary gain	61.3	0.0	61.3	
Net earnings	76.2	14.4	61.8	

Queen of the North

On March 22, 2006 the *Queen of the North*, operating on its regular route from Prince Rupert to Port Hardy, ran aground on Gil Island in Wright Sound and subsequently sank. Two passengers remain unaccounted for and are presumed to have perished.

An emergency environmental plan was implemented in conjunction with external authorities. Burrard Clean Operations, under contract to us, led the containment activities at the incident site using 1,800 metres of barrier boom to protect sensitive areas. We continue to monitor the situation and are currently investigating the feasibility of recovering the fuel and lubricants remaining in the vessel.

The Transportation Safety Board, as the lead investigation agency, along with Transport Canada and the RCMP, are conducting investigations related to the sinking. We are also conducting our own internal investigation.

A tug and barge service, as well as air service, was used as an interim measure to ensure that supplies reached the Queen Charlotte Islands and passengers requiring passage were accommodated. The *Queen of Prince Rupert*, which was undergoing refit at the time of the sinking, returned to service on the north coast route on April 19th. For the busy summer period, we have augmented service provided by the *Queen of Prince Rupert* with additional tug and barge and air service.

We maintain commercial insurance coverage for incidents of this nature. Insurance proceeds, net of deductible, of $67.9 million were received in May 2006 in settlement of the claim under the hull and machinery policy. In accordance with generally accepted accounting principles, $6.6 million of the insurance proceeds were recorded as a receivable to offset insurable losses in fiscal 2006. We have reported an extraordinary gain of $61.3 million for this event in the first quarter of fiscal 2007. These funds will be utilized to partially fund the acquisition of a new vessel. Claims for loss of life, personal belongings of passengers, passenger automobiles, and other types of claims are in the process of settlement. We expect that substantially all passenger claims, claims from other parties and costs incurred for environmental containment or cleanup will be paid by our liability insurer.

Our hull and machinery insurance policies have subsequently been renewed with an increase in annual premium costs of approximately $1.5 million. We expect that foregone revenues from the loss of the *Queen of the North* will be largely offset by avoided operating costs and interest income on invested insurance proceeds.

We have not observed any measurable impact on traffic levels elsewhere in our system that we attribute to this unfortunate event.

We are conducting an international search to lease or purchase a replacement vessel. However, it is important to note that if we do find a replacement vessel for the *Queen of the North*, it will take several months to certify and refit the vessel to our requirements, implement a safety management system and train our crews. We also plan to accelerate the process for the construction of a second northern vessel to replace the 40-year old *Queen of Prince Rupert.* We anticipate a third replacement vessel for the northern service will be acquired and in service in 2011. Negotiations have commenced with the Provincial government regarding financial support of the northern routes.

In accordance with the terms of the Coastal Ferry Services Contract with the Province, we filed a notice of force majeure and are in discussions with the Province as to the appropriate level of service to be provided until a replacement vessel is in place. It is uncertain at this time what the impact of this incident will be on related ferry service fees. The impact, if any, is expected to be known by the end of the fiscal year.

Revenue

Our total revenues for the first quarter of fiscal 2007 have increased over the first quarter of fiscal 2006, as shown in the table below.

	Three Months Ended June 30			
			Increase(Decrease)	
($millions)	2006	2005	$	%
Tariff – vehicles	56.3	56.9	(0.6)	(1.1%)
Tariff – passengers	33.3	32.8	0.5	1.5%
Ferry service fees	27.1	27.0	0.1	0.4%
Federal-provincial subsidy	6.3	6.2	0.1	1.6%
Retail	17.6	17.3	0.3	1.7%
Other income	5.6	5.0	0.6	12.0%
Total revenue	146.2	145.2	1.0	0.7%

The decrease in vehicle tariff revenue in our first quarter of fiscal 2007 compared to the first quarter of fiscal 2006 is a result of overall lower average tariff rates and decreased traffic volumes. Although the annual average tariff rate on our three major routes connecting Vancouver Island to the mainland increased by 2.8% and on the remaining routes by 4.4% as permitted by the *Coastal Ferry Act*, discounts offered on the major routes contributed to vehicle tariff revenues being $0.6 million lower in the first quarter of fiscal 2007 than the first quarter of fiscal 2006.

Vehicle Traffic Volume	Three months ended June 30			
			Increase(Decrease)	
	2006	2005	#	%
Major routes	969,927	966,998	2,929	0.3%
Other routes	1,218,050	1,226,702	(8,652)	(0.7%)
Total	2,187,977	2,193,700	(5,723)	(0.3%)

Vehicle traffic volume on our major routes increased 0.3% in the first quarter of fiscal 2007 compared to the first quarter of fiscal 2006. The increase is primarily related to the timing of the Easter weekend. Fiscal 2007 included an Easter weekend while fiscal 2006 did not.

Vehicle traffic volume on other routes is down 0.7% in the first quarter of fiscal 2007 compared to the first quarter of fiscal 2006. A portion (3,867) of this decrease results from the reduced level of service on our northern routes subsequent to the loss of the *Queen of the North*.

Passenger Traffic Volume	Three months ended June 30			
			Increase(Decrease)	
	2006	2005	#	%
Major routes	2,819,300	2,792,849	26,451	0.9%
Other routes	2,707,569	2,724,922	(17,353)	(0.6%)
Total	5,526,869	5,517,771	9,098	0.2%

Total passenger traffic in the first quarter of fiscal 2007 increased by 0.2% from the first quarter of fiscal 2006. The major routes experienced a 0.9% increase in the quarter due to the timing of Easter weekend. Other routes experienced reduced passenger traffic. A significant portion (12,336) of this reduction was due to the reduced level of service on our northern routes.

Ferry service fees were higher in our first quarter of fiscal 2007 than the first quarter of fiscal 2006 due to an increase of $0.1 million (3.1%) in social program fees. 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 generally the same each year. Social program fees are based on usage. Because of the loss of the *Queen of the North*, we are currently in discussions with the Province as to the appropriate level of service to be provided on our northern routes until a replacement vessel is in place. It is uncertain at this time what the impact of this incident will be on related ferry service fees. The impact, if any, is expected to be known by the end of the 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 Vancouver Consumer Price Index.

Retail revenue includes food and other retail merchandise sales. Revenue from food sales grew 1.7% in our first quarter of fiscal 2007 over the first quarter of fiscal 2006, the increase reflecting a 1.2% higher spending per passenger and a 0.4% increase in passenger traffic on routes providing catering service. While retail revenues increased $0.6 million or 4.7% on the major routes, this was largely offset by fewer on board services and less traffic volume on our northern routes due to the replacement service for the *Queen of the North*.

The increase in other income reflects reservation revenues that were $0.4 million higher in our first quarter of fiscal 2007 compared to the first quarter of fiscal 2006. We experienced $0.3 million higher revenue from reservations on our major routes and $0.1 million on the Horseshoe Bay-Langdale route due to higher usage. We also experienced a $0.2 million increase in assured loading ticket surcharges and a $0.1 million increase in parking fees at the terminals serving our major routes.

Expenses
Expenses for the first quarter of fiscal 2007 have increased over the first quarter of fiscal 2006, as shown in the table below.

	Three Months Ended June 30			
			(Increase)Decrease	
Expenses ($millions)	2006	2005	$	%
Operations	75.7	75.0	(0.7)	(0.9%)
Maintenance	17.9	18.1	0.2	1.1%
Administration	12.6	12.0	(0.6)	(5.0%)
	106.2	105.1	(1.1)	(1.0%)
Cost of retail goods sold	6.8	6.9	0.1	1.4%
Amortization	13.0	12.1	(0.9)	(7.4%)
	126.0	124.1	(1.9)	(1.5%)
Gain on foreign exchange	(0.1)	(0.1)	0.0	
Interest expense	5.4	6.8	1.4	20.6%
	5.3	6.7	1.4	20.9%
Total expenses	131.3	130.8	(0.5)	(0.4%)

The total increase in operations expenses from the first quarter of fiscal 2007 to the first quarter of fiscal 2006 was $0.7 million. The most significant items were: an increase of $2.6 million in wages and benefits (due to wage increases, Transport Canada requirements and timing of Easter weekend) and $0.4 million in marine insurance; partially offset by a decrease of $1.7 million in property taxes and $0.6 for a planned reduction in advertising costs.

Maintenance expenses which include expenditures for vessel refit and maintenance as well as terminal maintenance activities were $0.2 million lower in our first quarter of fiscal 2007 than the first quarter of fiscal 2006.

Administration expenses increased $0.6 million in the first quarter of fiscal 2007 over the first quarter of fiscal 2006. This was primarily due to a planned increase in corporate information technology support resulting from the many new initiatives and upgrades in our computer systems.

Amortization increased by a total of $0.9 million in the first quarter of fiscal 2007 from the first quarter of fiscal 2006. This reflects the additional assets that came into service during the past 12 months, the most significant being vessel upgrades and modifications.

Interest expenses in the first quarter of fiscal 2007 decreased a total of $1.4 million over the first quarter of fiscal 2006. This reflects a $0.7 million recapture of interest through the Government of Canada structured financing facility program in the first quarter of fiscal 2007 and $0.5 million higher capitalized interest.

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. At the start of each fiscal year, the set prices increase by the Consumer Price Index (Vancouver). The first such increase, effective April 1, 2005, was 2.0%. The Commissioner ordered an additional 5% increase in the set price per route group effective July 24, 2005. On April 1, 2006 our set prices increased a further 1.9%.

Differences in fuel costs arising from our actual price paid per litre being higher or lower than the unit set price are charged or credited to the deferred fuel cost accounts.

Continuing high fuel costs have caused increases in the balances of the deferred fuel cost accounts. We filed applications with the British Columbia Ferries Commissioner under section 42 of the *Coastal Ferry Act* requesting extraordinary price cap increases to allow for fuel surcharges in order to reduce or eliminate these balances. After receiving approval, we implemented fuel surcharges on July 25, 2005, February 1, 2006 and again on June 22, 2006. Proceeds from the fuel surcharges are credited against balances in the deferred fuel cost accounts. In spite of these actions and of fuel savings measures taken, the balances in our deferred fuel cost accounts totalled $23.9 million at June 30, 2006 ($22.7 million at March 31, 2006).

The Commissioner has also set an efficiency target requiring us to reduce fuel consumption by 1% in fiscal year 2007 and by an additional 1% in fiscal year 2008. We filed our fuel savings plan with the Commissioner in June 2006. This plan is available on our website at www.bcferries.com.

We are continuing to implement a wide variety of fuel saving measures ranging from operating our vessels more efficiently to installing new, more fuel-efficient engines on some of our vessels and fuel monitoring systems on others. Over the past three years we have decreased our annual consumption by over 7 million litres (5.6%).

All of the Commissioner's orders can be viewed on the Commissioner's website at www.bcferrycommission.com.

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. Our liquidity and capacity to access capital markets to maintain operations and fund growth remains substantially unchanged since March 31, 2006.

Sources & Uses of Cash

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.

Sources and uses of cash and cash equivalents for the first quarter of fiscal 2007 and the first quarter of fiscal 2006 are summarized in the table below.

($millions)	Three Months Ended June 30 2006	2005
Net earnings before extraordinary gain	14.9	14.4
Extraordinary gain	61.3	0.0
Net earnings for the period	76.2	14.4
Items not involving cash:		
Amortization	13.0	12.1
Other non-cash charges	0.2	0.0
Regulatory costs deferred	(1.2)	(5.2)
Change in operating working capital	(30.8)	(12.4)
Cash provided by operating activities	57.4	8.9
Cash used in financing activities	(0.1)	0.0
Cash used in investing activities	(31.8)	(33.8)
Total increase (decrease) in cash	25.5	(24.9)

Cash provided by operating activities was $57.4 million for the first quarter of fiscal 2007. This included an extraordinary gain of $61.3 million from insurance proceeds regarding the loss of the *Queen of the North.* Also included in cash from operating activities was an increase in non-cash working capital of $30.8 million. This working capital increase was primarily due to:

- $33.8 million decrease in payables and accrued liabilities. In April 2006 we paid $6.1 million of goods and services tax resulting from a notice of reassessment of input tax credit claims. We disagree with the reassessment and continue to pursue recovery through the appeal process. The majority of the remainder related to vessel refits done during the latter part of fiscal year 2006;
- $5.2 million increase in prepaid expenses relating to an increase in fuel costs ($3.5 million), insurance premiums ($1.1 million) and property taxes ($0.9 million);

The working capital increase was partially offset by:

- $6.8 million decrease in accounts receivable, mainly as a result of the receipt of $6.6 million of insurance proceeds in connection with the *Queen of the North* incident described above.

Cash used in investing activities was $31.8 million representing capital expenditures. The significant capital expenditures in the first quarter of fiscal 2007 are described below in “Investing in Our Capital Assets”.

Investing in our Capital Assets

Capital expenditures in the first quarter of fiscal 2007 totalled $23.5 million. This level of expenditure reflects significant investments in our fleet, terminals and information systems to increase customer service and operating efficiency. Expenditures included:

- $15.3 million in vessel upgrades and modifications including:
  - $10.6 million of a $38.2 million mid-life upgrade which includes safety, structural and mechanical improvements to the *Queen of Surrey;*
  - $1.3 million of the $11.8 million project to reconstruct Hull 259, formerly the *John Atlantic Burr*;
  - $0.8 million on the Super C new vessel construction project; and
  - $0.5 million for replacement of the emergency generator on the *Queen of Coquitlam*;
- $5.6 million in marine structures of which $3.7 million is for berth reconstruction at Swartz Bay terminal;
- $1.4 million in software development which will enhance customer service in areas such as reservations, provide improvements in retail and food service management and allow operational efficiencies in crew scheduling; and
- $0.9 million in terminal and building upgrades.

Major Vessel Upgrades

The *Queen of Surrey*, which provides service on our Langdale-Horseshoe Bay route, returned to service on June 27, 2006, following an extensive $38.2 million mid-life upgrade. The 25-year-old vessel underwent 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 mid-life upgrade. Similar upgrades have already been undertaken on the *Queen of Coquitlam*, *Queen of Cowichan* and *Queen of Oak Bay.* The remaining C-class vessel, the *Queen of Alberni,* is scheduled to undergo its mid-life upgrade in fiscal 2008.

Hull 259 – vessel yet to be named

In August 2005, we acquired a ferry from the State of Utah for $200,000 (US) through a competitive bid process. This vessel, originally the *John Atlantic Burr*, is similar in design to our three "K-class" vessels, the *Kahloke,* the *Klitsa* and the *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 is currently undergoing major reconstruction to upgrade it to our standards and the requirements of Transport Canada and to expand its vehicle carrying capacity. The new vessel, yet to be named, is expected to be ready for service in December 2006.

"Super C" Class new vessel construction

On September 17, 2004 we entered into contracts with Flensburger Schiffbau-Gesellschaft ("FSG") of Germany 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 *Coastal Renaissance*, *Coastal Inspiration* and *Coastal Celebration*, 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. The detailed design is close to complete and steel cutting is expected to begin in late August 2006. The first vessel is expected to be delivered in

December 2007. Foreign currency based payments in this project have been hedged in Canadian dollars to manage the foreign exchange risk. We expect this project to be completed on schedule and within budget.

New intermediate vessel construction
On July 5, 2006, we signed a $45.5 million contract with Vancouver Shipyards, a Washington Marine Group company, to build a new 125-car ferry to replace the 46-year-old *Queen of Tsawwassen*. Under the fixed price contract, the shipyard is responsible for the detailed design and construction of the vessel and guarantees performance related to speed, carrying capacity, manoeuvrability, fuel consumption and delivery. Construction of the 100 metre vessel will begin later this year and the vessel is expected to be in service by the summer of 2008.

Swartz Bay Terminal Marine Structures
In the first quarter of fiscal 2007, we spent $3.7 million of a total project estimated to be $24.9 million for the construction of a new vehicle ramp and passenger walkway at berth 2 at Swartz Bay terminal. The majority of the work was performed in fiscal 2006 and the project is expected to be complete by the end of August 2006.

Information Technology
In the first quarter of fiscal 2007, we spent $0.5 million 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. The total project budget is $4.4 million.

Other ongoing projects include a new time collection system and new reporting initiatives, enhanced crew scheduling system and improved voice recognition system for reservations, automated ticketing and security projects. These projects focus on obtaining efficiencies, improving safety and security and providing better service to our customers.

Quarterly Financial Highlights
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.

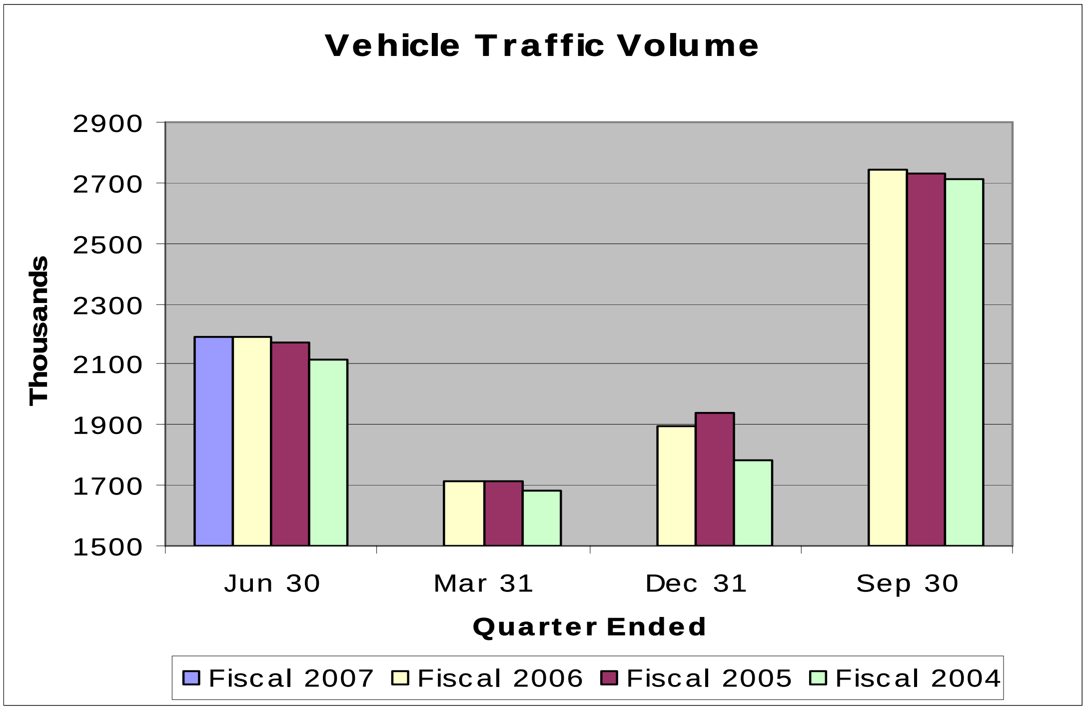
The table below compares earnings by quarter for the most recent eight quarters.

	Quarter Ended (unaudited)							
($millions)	Jun 06	Mar 06	Dec 05	Sep 05	Jun 05	Mar 05	Dec 04	Sep 04
Total revenue	146.2	109.7	126.0	198.3	145.2	107.0	122.7	194.4
Earnings (loss) from operations	20.2	(18.7)	5.4	67.3	21.1	(23.8)	3.6	67.9
Net earnings (loss) before extraordinary items	14.9	(24.8)	(0.9)	61.2	14.4	(31.3)	(4.2)	63.0
Extraordinary gain	61.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net earnings (loss)	76.2	(24.8)	(0.9)	61.2	14.4	(31.3)	(4.2)	63.0

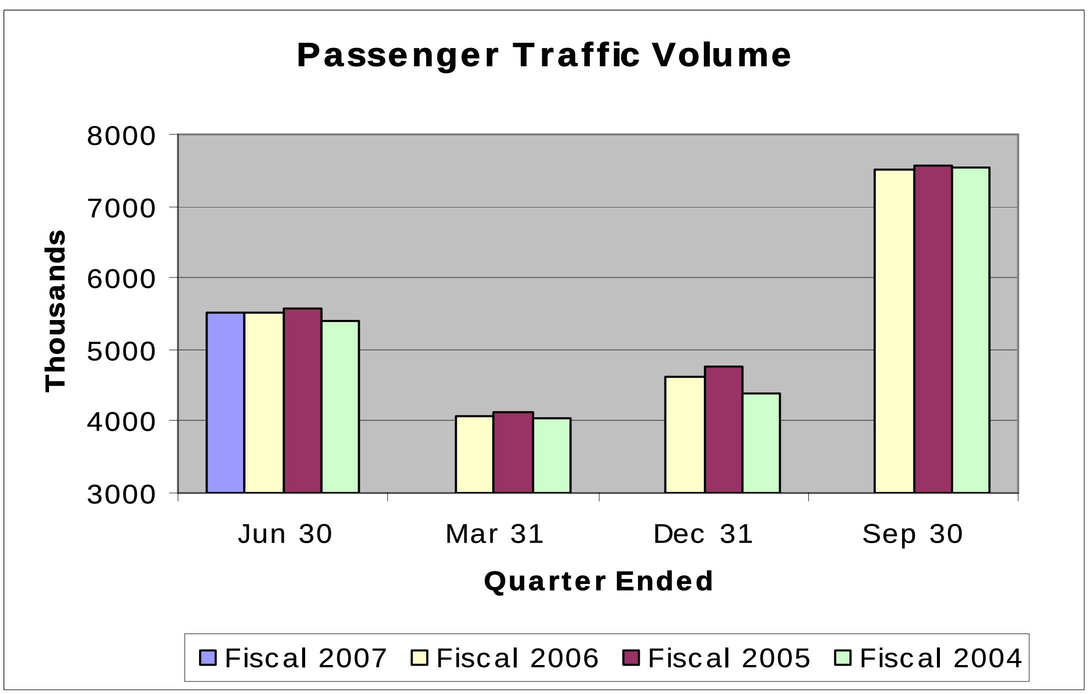
Net losses in the quarters ended March 2006 and December 2005 and net earnings before extraordinary gains in the quarter ended June 2006 were better than the same quarter in the previous year ranging from $0.5 million to $6.5 million. In the quarter ended September 2005, compared to the quarter ended September 2004, net earnings were lower by $1.8 million. The average increase in net earnings before extraordinary items for the latest four quarters was $2.1 million or 20.3%.

Total revenue in each of the latest four quarters was higher than the corresponding quarter from the previous fiscal year. The most significant contributing factors to the trend were higher tariff revenue as a result of increases in tariff rates and growth in retail and other income. As mentioned earlier in this report, 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.

Vehicle traffic decreased in the quarters ended June 2006 and December 2005 compared to the corresponding quarter in the previous year (0.3% and 2.5% respectively). In the quarters ended March 2006 and September 2005, we experienced a modest increase, resulting in a net four-quarter decrease of 0.5%. We believe that the lower than expected traffic levels are primarily due to reduced levels of tourism. The following graph shows the relationship of the quarters over the past three years.



Passenger traffic in the quarter ended June 2006 increased 0.2% over the quarter ended June 2005. Passenger traffic in all quarters of fiscal 2006 was lower than the corresponding quarters in the previous fiscal year. The average decrease of the latest four quarters was 1.0%. As previously mentioned, we believe the decrease in passenger traffic is primarily due to reduced levels of tourism. Following is a graph showing the relationship of the quarters over the past three years.



OUTLOOK

Traffic

Ferry traffic levels are affected by a number of factors including high motor fuel costs, a strong Canadian dollar, the public's concerns regarding security and health, disposable personal income, the local economy and population growth. We anticipate only modest traffic volume increases over the next few years.

Market Growth

Notwithstanding the pressure on traffic volumes, we see some opportunities for growth. We received approximately 2.4 million unique visitors to our website in fiscal 2006, up 21 percent from the previous fiscal year. In the first quarter of fiscal 2007, we had 0.7 million unique visitors which is an increase of 24 percent over the first quarter of fiscal 2006. 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.

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.

We have experienced a steady growth in ancillary revenues. We see continuing opportunities to improve the revenue from our ancillary services including reservations, food and retail and assured loading.

Queen of the North

Our hull and machinery insurance policies have been renewed with an increase in annual premium costs of approximately $1.5 million as a direct result of the sinking of the *Queen of the North*. We expect that foregone revenues from the loss of the *Queen of the North* will be largely offset by avoided operating costs and interest income on invested insurance proceeds.

In accordance with the terms of the Coastal Ferry Services Contract, we filed a notice of force majeure and are in discussions with the Province as to the appropriate level of service to be provided until a replacement vessel is in place. It is uncertain at this time what the impact of this incident will be on related ferry service fees. The impact, if any, is expected to be known by the end of the fiscal year.

Asset Renewal 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 will continue with our fleet and asset renewal program. We expect to spend more than $1.2 billion over the next three years to upgrade and replace our aging assets. Until we are able to upgrade and replace a large share of our fleet through new vessel acquisitions and our revitalization program, we expect that reliability issues may continue to challenge our operations.

We continue to reinvest our retained earnings into our asset renewal program. As the capital projects are completed and come into service, amortization and financing costs will climb. Consistent with our expectations, this will cause a substantial decrease in our future earnings.

Regulation

Transport Canada regulates safety on our vessels by authority of the *Canada Shipping Act*. It is expected that a revised Act and more stringent regulations will be introduced in the near future. 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.

Our first performance term ends March 31, 2008. We must provide the British Columbia Ferries Commissioner with the information required under the *Coastal Ferry Act* in order for the Commissioner to set price caps for the next performance term. The deadline for filing our submission is September 30, 2006. This process will result in the setting of price caps for the second performance term ending March 31, 2011.

Competition

New competitors have emerged in both the passenger only market as well as the commercial traffic market in the past few years. To date, passenger only competitors have not been successful at sustaining operations. Competition may increase in these markets with the potential emergence of alternate 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 alternative service providers, in an effort to reduce costs and provide services on our regulated routes, as mandated by the *Coastal Ferry Act*. While we maintain responsibility for the long-term delivery of ferry services, we are required to test the market to determine if another operator, under contract to us, can provide a more cost-effective service offering. We expect to issue a Request for Proposal to two proponents on the Brentwood Bay-Mill Bay route later this year. We also expect to issue a Request for Proposals regarding the operation of our four routes north of Port Hardy. However, due to the loss of the *Queen of the North,* the timing of this request is uncertain.

RISK MANAGEMENT

Understanding and managing risk are important parts of our business. A discussion of enterprise wide risk management can be found on pages 22 through 26 of our fiscal 2006 annual Management's Discussion and Analysis. Our risk profile is substantially unchanged during the first three months of fiscal 2007.

ACCOUNTING PRACTICES

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with Canadian generally accepted accounting principles.

Our significant accounting policies are contained in note 1 to our March 31, 2006 and June 30, 2006 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.

Further discussion of our most critical accounting policies and estimates that have been used in the preparation of our consolidated financial statements can be found on pages 26 through 29 of our fiscal 2006 annual Management's Discussion and Analysis.

FORWARD LOOKING STATEMENTS

This management's discussion and analysis contains certain "forward looking statements". These statements relate to future events or future performance and reflect management's expectations regarding our growth, results of operations, performance, business prospects and opportunities and industry performance and trends. They reflect management's current internal projections, expectations or beliefs and are based on information currently available to management.

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.