Management's Discussion and Analysis
of Financial Condition and Results of Operations
For the nine months ended December 31, 2006
Dated February 1, 2007

The following is our discussion and analysis of the financial condition and results of operations for British Columbia Ferry Services Inc. as of February 1, 2007. 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, 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, providing frequent year-round transportation service on 25 routes, supported by 36 vessels and 47 terminals. The newest additions to our fleet include the *Kuper* which is expected to come into service in February 2007 and the *Northern Adventure* which is expected to come into service in the spring of 2007 (see below for more detail). 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 December 31, 2006 (the third quarter of fiscal 2007), we provided over 46,000 sailings, carrying 4.6 million passengers and 1.9 million vehicles.

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

- In November 2006, construction commenced on the second of three new Super C-class vessels, the *Coastal Inspiration*. The Super C-class vessels will be the largest double-ended ferries in the world. They will feature a diesel-electric propulsion system that is the largest and most fuel efficient of its kind. Construction of the first vessel, *Coastal Renaissance*, started in August 2006 and construction of a third vessel, *Coastal Celebration*, is expected to begin in April 2007. Delivery of the first vessel is expected in late 2007. Delivery of the other two Super C-class vessels is expected in early and mid 2008, respectively. The total project budget for the three vessels is $542 million. The project is currently within budget and ahead of schedule. See "Investing in our Capital Assets" below for more detail.
- In November 2006, a new addition to our fleet, the *Kuper*, was officially named and launched. This $12 million, 32-vehicle ferry will enter service on our smaller island routes in February 2007 following training, certification and sea trials. See "Investing in our Capital Assets" below for more detail.

- In December 2006, the *Northern Adventure* (formerly the *Sonia*), arrived in British Columbia following a four-week journey from Greece. The two-year-old vessel, a replacement for the *Queen of the North,* was purchased for $51 million in October 2006. The import duty and taxes on this vessel purchase totalled $17 million. The vessel is currently undergoing significant modifications at Victoria Shipyards to improve customer amenities and meet safety requirements to operate in Canadian waters. The total project budget for the acquisition and modification of this vessel is $103 million. The vessel is expected to enter service in the spring of 2007, in time to relieve the *Queen of Prince Rupert* for its annual refit. See "Investing in our Capital Assets" below for more detail.
- In December 2006, construction commenced on the new intermediate class ferry that will replace the 46-year-old *Queen of Tsawwassen*. Once complete, the vessel will measure 100-metres long and will feature a new state-of-the-art lifesaving system as well as a variety of amenities including a comfortable lounge and snack bar for passengers to enjoy. The vessel, with a total project budget of $57 million, is expected to be in service by the summer of 2008. See "Investing in our Capital Assets" below for more detail.
- In January 2007, we received the final report from the independent review of our safety policies, procedures and practices. The report summary overview included the following conclusion: "*We concluded from our review that, overall, the company is operating a safe coastal ferry transportation system. The company directors, management and staff are highly committed to operational safety, both for the travelling public and for BC Ferries personnel. Nevertheless, there are a number of areas identified in this report where safety and related administrative processes and procedures should be strengthened.*" The report makes 41 recommendations on safety enhancements which we plan to implement. See "Risk Management" below for more detail.

FINANCIAL AND OPERATIONAL OVERVIEW

This section provides an overview of our financial and operational performance for the three months ended December 31, 2006 compared to the three months ended December 31, 2005 as well as the nine months ended December 31, 2006 (year-to-date) compared to the nine months ended December 31, 2005.

Our consolidated net loss in the three months ended December 31, 2006 was $0.9 million higher than the three months ended December 31, 2005. Our consolidated net earnings before extraordinary gain for the nine months ended December 31, 2006 was $7.3 million or 9.8% higher than the nine months ended December 31, 2005.

The extraordinary gain of $61.3 million is as a result of insurance proceeds received in the first quarter of fiscal 2007 regarding the loss of the *Queen of the North* as described below.

	Three Months Ended December 31				Nine Months Ended December 31			
			Variance				Variance	
($ millions)	2006	2005	$	%	2006	2005	$	%
Total revenue	128.4	126.1	2.3	1.8%	477.4	469.5	7.9	1.7%
Expenses	(125.9)	(120.7)	(5.2)	(4.3%)	(381.8)	(375.7)	(6.1)	(1.6%)
Earnings from operations	2.5	5.4	(2.9)	(53.7%)	95.6	93.8	1.8	1.9%
Interest and other	(4.3)	(6.3)	2.0	31.7%	(13.6)	(19.1)	5.5	28.8%
Net (loss) earnings before extraordinary gain	(1.8)	(0.9)	(0.9)	(100.0%)	82.0	74.7	7.3	9.8%
Extraordinary gain	0.0	0.0	0.0		61.3	0.0	61.3	
Net (loss) earnings	(1.8)	(0.9)	(0.9)	(100.0%)	143.3	74.7	68.6	91.8%

Northern Service
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 in concert with our commercial insurer, have investigated the feasibility and risk of recovering any fuel and lubricants that may remain in the vessel. The findings have been provided to the Canadian Coast Guard and we are currently awaiting their direction as to whether or not to proceed with fuel recovery.

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. For the busy summer period, we 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 reported an extraordinary gain of $61.3 million for this event in the first quarter of fiscal 2007. These funds are being utilized to partially fund the acquisition of the *Northern Adventure.* See “Investing in our Capital Assets” below for more detail. Claims for personal belongings of passengers and passenger automobiles are substantially complete. Other types of claims are still in progress. 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. This has been more than offset by $1.9 million of interest income earned to date on invested insurance proceeds.

In December 2006, the *Northern Adventure* arrived in British Columbia following a four-week journey from Greece. The two-year-old vessel was purchased for $51 million in October 2006. The import duty and taxes on this vessel purchase totalled $17 million. We are currently seeking a remission of the import duty, but we are uncertain as to the outcome of this application. The vessel is currently undergoing significant modifications at Victoria Shipyards to meet safety requirements to operate in Canadian waters, improve customer amenities and enable the vessel to fit our berths. The total project budget for the acquisition and modification of this vessel is $103 million. The vessel is expected to enter service next spring, in time to relieve the *Queen of Prince Rupert* for its annual refit.

We have also commissioned the building of the *Northern Expedition*, to replace the 40-year-old *Queen of Prince Rupert*, which we expect to be in service in the spring of 2009. The contract to build the new vessel is with Flensburger Schiffbau–Gesellschaft (“FSG”) of Germany. Its total value of $133 million, together with related import duties and taxes of approximately $43 million, constitute the majority of the total project budget of $200 million. Negotiations have been concluded with the Provincial government resulting in increases to service fees to support the deployment of these two vessels on the northern routes.

We anticipate a third replacement vessel for the northern service will be acquired and in service during our next performance term (April 1, 2008 to March 31, 2012). Negotiations with the Provincial government with respect to this vessel are ongoing.

In accordance with the terms of the Coastal Ferry Services Contract with the Province, we filed a notice of force majeure and have begun discussions with the Province as to the replacement service that was provided over the summer period during this fiscal year. The Province has not yet agreed that the events surrounding the loss of the *Queen of the North* constitute an event of force majeure and it is uncertain 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 three months ended December 31, 2006 have increased $2.3 million or 1.8% over the three months ended December 31, 2005 ($7.9 million or 1.7% year-to-date), as shown in the table below.

	Three Months Ended December 31				Nine Months Ended December 31			
			Increase				Increase	
($ millions)	2006	2005	$	%	2006	2005	$	%
Tariff - vehicles	47.7	47.4	0.3	0.6%	183.7	182.2	1.5	0.8%
Tariff - passengers	27.6	27.3	0.3	1.1%	112.2	110.6	1.6	1.4%
Ferry service fees	25.7	25.4	0.3	1.2%	84.3	83.6	0.7	0.8%
Federal-provincial subsidy	6.3	6.2	0.1	1.6%	19.0	18.7	0.3	1.6%
Retail	15.9	14.7	1.2	8.2%	58.6	56.5	2.1	3.7%
Other income	5.2	5.1	0.1	2.0%	19.6	17.9	1.7	9.5%
Total revenue	128.4	126.1	2.3	1.8%	477.4	469.5	7.9	1.7%

The improvement in vehicle tariff revenue in the three and nine months ended December 31, 2006, compared to the three and nine months ended December 31, 2005, is mainly a result of higher overall tariff rates. The annual average tariff rate increase was 2.8% on our three major routes connecting Vancouver Island to the mainland and 4.4% on the remaining routes, as permitted by the *Coastal Ferry Act*. Tariff revenue increases from higher vehicle traffic volumes on the major routes were offset by revenue reductions associated with the loss of the *Queen of the North.* Also affecting our revenues, particularly on our other routes, were service disruptions resulting from significant storm activity in the three month period ending December 31, 2006.

Vehicle Traffic Volume	Three Months Ended December 31			
			Increase (Decrease)	
	2006	2005	#	%
Major routes	832,992	827,320	5,672	0.7%
Northern routes	4,161	5,083	(922)	(18.1%)
Other routes	1,038,434	1,060,061	(21,627)	(2.0%)
Total	1,875,587	1,892,464	(16,877)	(0.9%)
	Nine Months Ended December 31			
			Increase (Decrease)	
	2006	2005	#	%
Major routes	3,084,809	3,065,249	19,560	0.6%
Northern routes	18,114	30,240	(12,126)	(40.1%)
Other routes	3,711,929	3,732,908	(20,979)	(0.6%)
Total	6,814,852	6,828,397	(13,545)	(0.2%)

Vehicle traffic volume on our major routes increased by 5,672 in the three months ended December 31, 2006 compared to the three months ended December 31, 2005 (19,560 year-to-date). The vehicle traffic volume on the northern routes decreased by 922 (12,126 year-to-date) as a result of the loss of the *Queen of the North.* The vehicle traffic volume on our other routes decreased by 21,627 (20,979 year-to-date) with the majority of the routes experiencing a decrease. In the three months ended December 31, 2006 inclement weather throughout our service areas negatively affected traffic volumes, particularly on our other routes. The snow and high winds resulted in 352 cancelled sailings, 248 more than the same period in the prior year.

Passenger Traffic Volume	Three Months Ended December 31			
			Increase (Decrease)	
	2006	2005	#	%
Major routes	2,327,342	2,328,773	(1,431)	(0.1%)
Northern routes	10,383	13,636	(3,253)	(23.9%)
Other routes	2,226,943	2,288,896	(61,953)	(2.7%)
Total	4,564,668	4,631,305	(66,637)	(1.4%)
	Nine Months Ended December 31			
			Increase (Decrease)	
	2006	2005	#	%
Major routes	9,168,360	9,104,840	63,520	0.7%
Northern routes	55,542	96,486	(40,944)	(42.4%)
Other routes	8,406,065	8,468,059	(61,994)	(0.7%)
Total	17,629,967	17,669,385	(39,418)	(0.2%)

Passenger traffic volume on our major routes decreased by 1,431 in the three months ended December 31, 2006 compared to the three months ended December 31, 2005 (increase of 63,520 year-to-date). The passenger traffic volume on the northern routes decreased by 3,253 (40,944 year-to-date) mainly as a result of the loss of the *Queen of the North*. The passenger traffic volume on our other routes decreased by 61,953 (61,994 year-to-date) with the majority of the routes experiencing a decrease. In the three months ended December 31, 2006 inclement weather also had an impact on passenger traffic volumes, particularly on our other routes.

Ferry service fees were higher in the three months ended December 31, 2006 compared to the three months ended December 31, 2005 mainly due to an increase of $0.3 million ($0.7 million year-to-date) in social program fees. These programs include discount fares for BC seniors, students traveling to and from school, persons with disabilities 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 have begun discussions with the Province as to the level of replacement service that was provided on our northern routes over the summer period. It is uncertain at this time what the impact of the loss of the *Queen of the North* 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. Retail revenue grew $1.2 million in the three months ended December 31, 2006 compared to the three months ended December 31, 2005 ($2.1 million year-to-date). This was despite a revenue reduction of $0.2 million ($1.9 million year-to-date) relating to the loss of the *Queen of the North* and any impact of severe storm conditions on traffic levels. The total year-to-date increase of 3.7% is mainly attributable to a year-over-year increase in spending per passenger. The largest increases were on the major routes, which had a $1.3 million increase for the three months ended December 31, 2006 ($3.5 million year-to-date).

The increase in other income reflects reservation revenues that were $0.4 million higher in the three months ended December 31, 2006 compared to the three months ended December 31, 2005 ($1.1 million year-to-date). This increase was due to higher usage on our major routes and the Horseshoe Bay-Langdale route. We also experienced a $0.1 million increase in assured loading ticket premiums ($0.5 million year-to-date) and a $0.1 million increase in parking fees at the terminals serving our major routes ($0.3 million year-to-date).

Expenses

Expenses for the three months ended December 31, 2006 increased $3.2 million or 2.5% over the three months ended December 31, 2005 ($0.6 million or 0.2% year-to-date), as shown in the table below.

	Three Months Ended December 31				Nine Months Ended December 31			
			(Increase)Decrease				(Increase)Decrease	
($ millions)	2006	2005	$	%	2006	2005	$	%
Operations	72.5	69.4	(3.1)	(4.5%)	231.5	229.4	(2.1)	(0.9%)
Maintenance	21.9	21.8	(0.1)	(0.5%)	53.1	53.0	(0.1)	(0.2%)
Administration	11.5	10.1	(1.4)	(13.9%)	33.9	32.5	(1.4)	(4.3%)
	105.9	101.3	(4.6)	(4.5%)	318.5	314.9	(3.6)	(1.1%)
Cost of retail goods sold	6.3	6.1	(0.2)	(3.3%)	22.9	21.9	(1.0)	(4.6%)
Amortization	13.7	13.3	(0.4)	(3.0%)	40.4	38.9	(1.5)	(3.9%)
	125.9	120.7	(5.2)	(4.3%)	381.8	375.7	(6.1)	(1.6%)
Gain on foreign exchange	0.0	0.0	0.0		(0.3)	(0.2)	0.1	
Interest expense	4.3	6.3	2.0	31.7%	13.9	19.3	5.4	28.0%
	4.3	6.3	2.0	31.7%	13.6	19.1	5.5	28.8%
Total expense	130.2	127.0	(3.2)	(2.5%)	395.4	394.8	(0.6)	(0.2%)

The total increase in operations expenses for the three months ended December 31, 2006 compared to the three months ended December 31, 2005 was $3.1 million ($2.1 million year-to-date). The most significant changes include: an increase of $2.8 million ($8.0 million year-to-date) in wages and benefits (due to wage increases, Transportation Canada requirements and timing of Easter weekend), an increase in marine insurance of $0.4 million ($1.1 million year-to-date) and other operating cost increases in the quarter. These increases are partially offset by a reduction of $1.5 million ($4.4 million year-to-date) in property taxes and a $1.1 million year-to-date reduction in costs due to the loss of the *Queen of the North*.

Maintenance expenses which include expenditures for vessel refit and maintenance as well as terminal maintenance activities were $0.1 million higher in the three months ended December 31, 2006 compared to the three months ended December 31, 2005 ($0.1 million year-to-date).

Administration expenses increased $1.4 million in the three months ended December 31, 2006 compared to the three months ended December 31, 2005 ($1.4 million year-to-date). The year-to-date increase was primarily due to a planned increase in corporate information technology support resulting from the many new initiatives and upgrades in our computer systems.

Cost of retail goods sold increased $0.2 million in the three months ended December 31, 2006 compared to the three months ended December 31, 2005 ($1.0 million year-to-date) reflecting the higher level of retail sales.

Amortization increased by $0.4 million in the three months ended December 31, 2006 compared to the three months ended December 31, 2005 ($1.5 million year-to-date). This reflects the additional assets that came into service during the past 12 months, the most significant being vessel upgrades and modifications.

Interest expense for the three months ended December 31, 2006 compared to the three months ended December 31, 2005 decreased a total of $2.0 million ($5.4 million year-to-date). Significant contributors are a $1.3 million recapture of interest through the Government of Canada structured financing facility program ($3.8 million year-to-date) and higher capitalized interest on construction in progress in the current fiscal year.

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 June 22, 2006.

Proceeds from the fuel surcharges are credited against balances in the deferred fuel cost accounts. Despite these actions, and fuel savings measures taken, the balances in our deferred fuel cost accounts totalled $26.0 million at December 31, 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.

During the year ended March 31, 2006, we decreased our annual consumption by over 7 million litres (5.6%) from the level of fuel consumed three years prior. 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. At this time we are on track to meet or exceed the fuel consumption target set by the Commissioner.

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 40% of the capital expenditures over the next decade, with the balance funded by borrowings. In May 2006 we renegotiated our credit facility with a syndicate of Canadian banks, secured by pledged bonds. This facility makes available a five year revolving facility in the amount of $155 million. 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 three and nine months ended December 31, 2006, and the three and nine months ended December 31, 2005, are summarized in the table below.

	Three Months Ended December 31		Nine Months Ended December 31	
($ millions)	2006	2005	2006	2005
Net (loss) earnings before extraordinary gain	(1.8)	(0.9)	82.0	74.7
Extraordinary gain	0.0	0.0	61.3	0.0
Net (loss) earnings for the period	(1.8)	(0.9)	143.3	74.7
Items not involving cash:				
Amortization	13.7	13.3	40.4	38.9
Other non-cash charges	0.2	0.4	0.7	0.6
Regulatory costs deferred	(0.6)	(4.2)	(3.1)	(12.6)
Change in operating working capital	14.5	(3.1)	(26.8)	(23.4)
Cash provided by operating activities	26.0	5.5	154.5	78.2
Cash provided (used) by financing activities	41.4	(0.6)	41.3	(0.6)
Cash used in investing activities	(101.9)	(37.2)	(176.1)	(84.3)
Total (decrease) increase in cash	(34.5)	(32.3)	19.7	(6.7)

Cash provided by operating activities was $26.0 million for the three months ended December 31, 2006 ($154.5 million year-to-date, including the extraordinary gain of $61.3 million). Also included in cash from operating activities was a decrease in non-cash working capital of $14.5 million (increase of $26.8 million year-to-date).

The working capital decrease for the three months ended December 31, 2006 was primarily due to:

- $8.5 million decrease in accounts receivable relating to timing of the receipt of structured financing facility payments ($1.9 million), insurance claims ($1.7 million), ferry transportation fees ($1.5 million), commercial travel card fees ($1.2 million) and social program fees ($0.8 million);
- $4.6 million decrease in prepaid expenses relating to fuel costs ($1.6 million), property taxes ($1.1 million), trade contracts ($1.5 million) and insurance premiums ($0.4 million);
- $7.9 million increase in accounts payable and accrued liabilities, mainly due to increased refit costs reflecting the seasonality of the business.

The working capital decrease was partially offset by a $7.3 million decrease in interest payable (semi-annual interest payments made in October and November).

Regulatory costs deferred are mainly comprised of $0.5 million increase in deferred fuel costs.

Cash provided by financing activities for the three months ended December 31, 2006 was $41.4 million reflecting a draw on our $155 million revolving credit facility.

Cash used in investing activities for the three months ended December 31, 2006 represents capital expenditures of $101.9. The significant capital expenditures for the three months ended December 31, 2006 are described below in “Investing in Our Capital Assets”.

The $26.8 million increase in non-cash working capital for the nine months ended December 31, 2006 was primarily due to:

- $24.2 million decrease in accounts payable 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 is related to vessel refits done during the latter part of fiscal year 2006;
- $1.6 million decrease in deferred revenue, mainly as a result of completion of our peak travel season resulting in a reduction in prepaid reservations. The reservation liability was reduced from $2.2 million at March 31, 2006 to $0.7 million at December 31, 2006;
- $7.3 million decrease in interest payable (semi-annual interest payments made in October and November); and
- $1.8 million increase in general inventories as a result of the current refit season.

These working capital increases were partially offset by an $8.7 million reduction in accounts receivable, including receipt of $5.4 million in property tax refunds resulting from favourable settlement of our 2004 and 2005 property tax appeals.

Regulatory costs deferred are mainly comprised of a $3.3 million increase in deferred fuel costs partially offset by $0.4 million proceeds from the sale of a financial derivative instrument.

Cash provided by financing activities for the nine months ended December 31, 2006 was $41.3 million which was primarily a draw on our $155 million revolving credit facility.

Cash used in investing activities for the nine months ended December 31, 2006 was $176.1 million representing capital expenditures. The significant capital expenditures in the nine months ended December 31, 2006 are described below in "Investing in Our Capital Assets".

Investing in our Capital Assets

Capital expenditures totalled $105.3 million in the three months ended December 31, 2006. The more significant expenditures included:

- $92.3 million in vessel upgrades and modifications including:
  - $69.4 million of the $103 million project for the purchase and modification of the *Northern Adventure*;
  - $6.7 million of the $40 million mid-life upgrade which includes safety, structural and mechanical improvements to the *Queen of Alberni*;
  - $6.2 million of the $57 million project to build a new intermediate vessel to replace the *Queen of Tsawwassen*;
  - $4.2 million of the $12 million project to reconstruct the *Kuper*; and
  - $2.0 million on two projects with a total budget of $3 million to install a series of ventilation fans to improve the air quality on the car decks of *Queen of Nanaimo* and the *Queen of Cowichan*.
- $10.0 million in marine structures at many of our terminals;
- $2.0 million in terminal and building upgrades and equipment; and
- $1.0 million in software development which will enhance customer service in areas such as automated ticketing, provide improvements in retail and food service management and facilitate operational efficiencies in crew scheduling.

Capital expenditures totalled $167.4 million in the nine months ended December 31, 2006. This level of expenditure reflects significant investment in our fleet, terminals and information systems to increase customer service and operating efficiency. Expenditures included:

- $136.5 million in vessel upgrades and modifications including:
  - $75.0 million of the $103 million project for the purchase and modification of the *Northern Adventure*;
  - $12.5 million of the $57 million project to build a new intermediate vessel to replace the *Queen of Tsawwassen*;
  - $10.9 million of the $37 million mid-life upgrade which includes safety, structural and mechanical improvements to the *Queen of Surrey*;
  - $8.3 million of the $542 million Super C-class new vessel construction project;
  - $7.1 million of the $40 million mid-life upgrade which includes safety, structural and mechanical improvements to the *Queen of Alberni*;
  - $7.1 million of the $200 million project for the construction of the new *Northern Expedition*; and
  - $7.1 million of the $12 million project to reconstruct the *Kuper*.
- $21.3 million in marine structures at many of our terminals, including:
  - $6.1 million of a $25 million project to complete a new berth at Swartz Bay terminal;
  - $4.9 million of a $16 million project to upgrade the berths at Departure Bay terminal; and
  - $3.1 million of a $12 million project to upgrade the berths at Horseshoe Bay terminal.
- $6.3 million in terminal and building upgrades and equipment; and
- $3.3 million in software development which will enhance customer service in areas such as automated ticketing, provide improvements in retail and food service management and allow operational efficiencies in crew scheduling.

Major Vessel Upgrades

In November 2006, the *Queen of Alberni*, which usually provides service on our Duke Point – Tsawwassen route, commenced a six-month $40 million mid-life upgrade at Vancouver Drydock in North Vancouver. This is the fifth, and final, C-class vessel to undergo such a major upgrade. The vessel's extensive upgrade will include safety and mechanical improvements, as well as new passenger amenities and will prepare the 30-year old vessel for another 20 years of service.

The *Queen of Surrey*, which provides service on our Langdale-Horseshoe Bay route, returned to service on June 27, 2006, following an extensive $37 million mid-life upgrade. The 25-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 Surrey* was the fourth of five C-class vessels identified for mid-life upgrade. Similar upgrades have already been completed on the *Queen of Coquitlam*, *Queen of Cowichan* and *Queen of Oak Bay.*

Kuper

In November 2006, a new addition to our fleet, the *Kuper*, was officially named and launched. This $12 million, 32-vehicle ferry will enter service on our smaller island routes in February 2007 following training, certification and sea trials. The *Kuper* is named after Kuper Island, which is located in Stuart Channel in the Southern Gulf Islands. The hull of the new vessel is comprised of the original structure of the *John Atlantic Burr*, which we purchased last year from the State of Utah Transportation Department. The vessel was disassembled in Utah and rebuilt with significant upgrades at Allied Shipbuilders in North Vancouver. During the construction period, a new 11-foot wide longitudinal section was inserted into the hull to provide an additional lane on the vehicle deck. The project also included new lifesaving equipment, navigational equipment, piping and electrical system. The *Kuper* is the fourth and largest of our "K-class" vessels, joining the *Kahloke,* the *Klitsa* and the *Kwuna*.

Northern Adventure

In December 2006, the *Northern Adventure* arrived in British Columbia following a four-week journey from Greece. The two-year-old vessel, a replacement for the *Queen of the North,* was purchased for $51 million in October 2006. The import duty and taxes on this vessel purchase totalled $17 million. We are currently seeking a remission of the import duty portion of this payment, but we are uncertain as to the outcome of this application. The vessel is currently undergoing significant modifications at Victoria Shipyards to update safety and security equipment, modify the stern to be compatible with our existing berths, upgrade electrical, heating and lighting systems and upgrade customer amenities. This 117-metre vessel has 70 state rooms and will accommodate over 600 passengers and 101 vehicles. The total project budget for the acquisition and modification of this vessel is $103 million. The vessel is expected to enter service in the spring of 2007, in time to relieve the *Queen of Prince Rupert* for its annual refit.

Northern Expedition

Following a rigorous competitive bidding process, we signed a $133 million contract with Flensburger Schiffbau-Gesellschaft ("FSG") of Germany to build a new vessel to replace the 40-year-old *Queen of Prince Rupert*, operating on our northern routes. The import duty and taxes on this contract will total approximately $43 million. We will be seeking a remission of the import duty, but we are uncertain as to the outcome of our future application. This design-build, fixed price contract (the majority of the total project budget of $200 million) provides us with substantial guarantees for delivery dates, performance criteria, cost certainty and quality of construction. Foreign currency based payments in this project have been hedged in Canadian dollars to manage the foreign exchange risk. This 150-metre vessel, which is expected to be in service in the spring of 2009, will have 55 staterooms and will accommodate 130 vehicles and 600 passengers.

"Super C" Class New Vessel Construction

In November 2006, construction commenced on the second of three new Super C-class vessels, the *Coastal Inspiration*. Construction of the first vessel, *Coastal Renaissance*, started in August 2006 and construction of a third vessel, *Coastal Celebration*, is expected to begin in April 2007. In September 2004, we entered into contracts with FSG of Germany to build these three new major vessels that will be the largest double ended vessels in the world. These are design-build, fixed price contracts, totalling $325 million. They provide us with substantial guarantees related to delivery dates, performance criteria, cost certainty and quality of construction. These contracts, together with the related import duty and taxes of approximately $112 million, form the majority of the total project budget of $542 million. We are currently seeking a remission of the import duty, but we are uncertain as to the outcome of this application. Foreign currency based payments in this project have been hedged in Canadian dollars to manage the foreign exchange risk.

These new vessels will replace aging vessels which currently provide service on our major routes. Delivery of the first vessel is expected in late 2007. Delivery of the other two Super C-class vessels is expected in early and mid 2008, respectively. This project is expected to be completed on schedule and within budget.

New Intermediate Vessel

On December 11, 2006 the keel was laid for the new intermediate class ferry at Vancouver Shipyards in North Vancouver. The $45.5 million contract with Vancouver Shipyards constitutes the majority of the total project budget of $57 million. The new intermediate vessel will allow for the retirement of the 46-year-old *Queen of Tsawwassen*. Once complete, the vessel will measure 100-metres in length and have a capacity of 600 passengers and 125 vehicles. It will feature a new state-of-the-art lifesaving system as well as a variety of amenities including a comfortable lounge and snack bar for passengers to enjoy. The vessel is expected to be in service by the summer of 2008.

Terminal Marine Structures

In October 2006 we officially opened a new state-of-the-art berth at Swartz Bay terminal on Vancouver Island. This $25 million project was undertaken to replace the outdated counter-weighted ramp lift system and certain old marine structures and brings a new level of technology to our berthing arrangements for our largest vessels. The improved design of this new floating berth will speed up the loading and unloading process with fewer ramp adjustments as the ramp rises and falls with the tide. This berth is now able to accommodate our Spirit-class vessels and will also be able to service the new Super C-class vessels.

In addition, berth upgrades are currently underway at Departure Bay and Horseshoe Bay as we reinvest in our terminal infrastructure and prepare for the arrival of the new Super C-class vessels.

Information Technology

In September 2006, we implemented an automated ticketing pilot project at our Tsawwassen and Swartz Bay terminals on our major routes. Foot passengers at these terminals now have the option of using the automated ticketing kiosks or a staffed ticket booth to purchase tickets. Passengers have the option to pay with either a debit or credit card at the kiosks. This project has been well received by our customers. We expect to proceed with implementing this technology at other locations in the near future.

We have also completed $1.9 million ($0.7 million in fiscal 2007) of a $4.5 million project to improve communication 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.

Other ongoing projects include a new time collection system and enhanced reporting initiatives, enhanced crew scheduling system, improved voice recognition system for reservations 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.

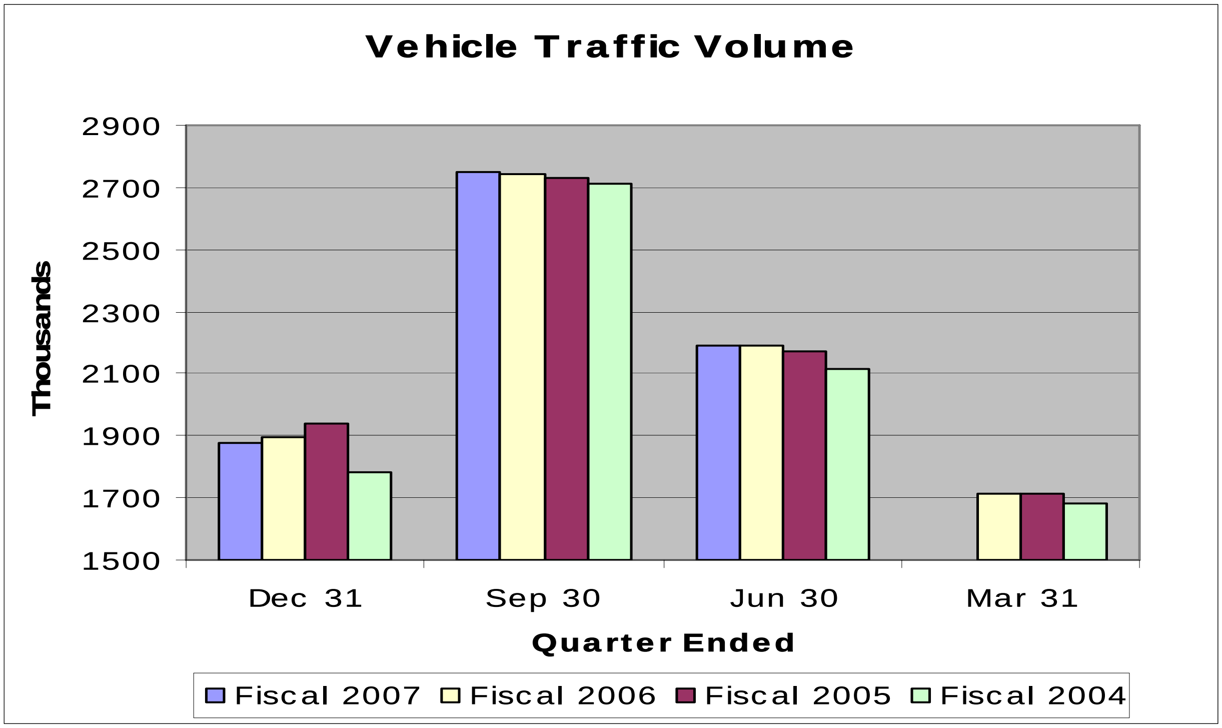
The table below compares earnings by quarter for the most recent eight quarters.

	Quarter Ended (unaudited)							
($millions)	Dec 06	Sep 06	Jun 06	Mar 06	Dec 05	Sep 05	Jun 05	Mar 05
Total revenue	128.4	202.7	146.2	109.7	126.0	198.3	145.2	107.0
Earnings (loss) from operations	2.5	73.0	20.2	(18.7)	5.4	67.3	21.1	(23.8)
Net (loss) earnings before extraordinary gain	(1.8)	68.9	14.9	(24.8)	(0.9)	61.2	14.4	(31.3)
Extraordinary gain	0.0	0.0	61.3	0.0	0.0	0.0	0.0	0.0
Net (loss) earnings	(1.8)	68.9	76.2	(24.8)	(0.9)	61.2	14.4	(31.3)

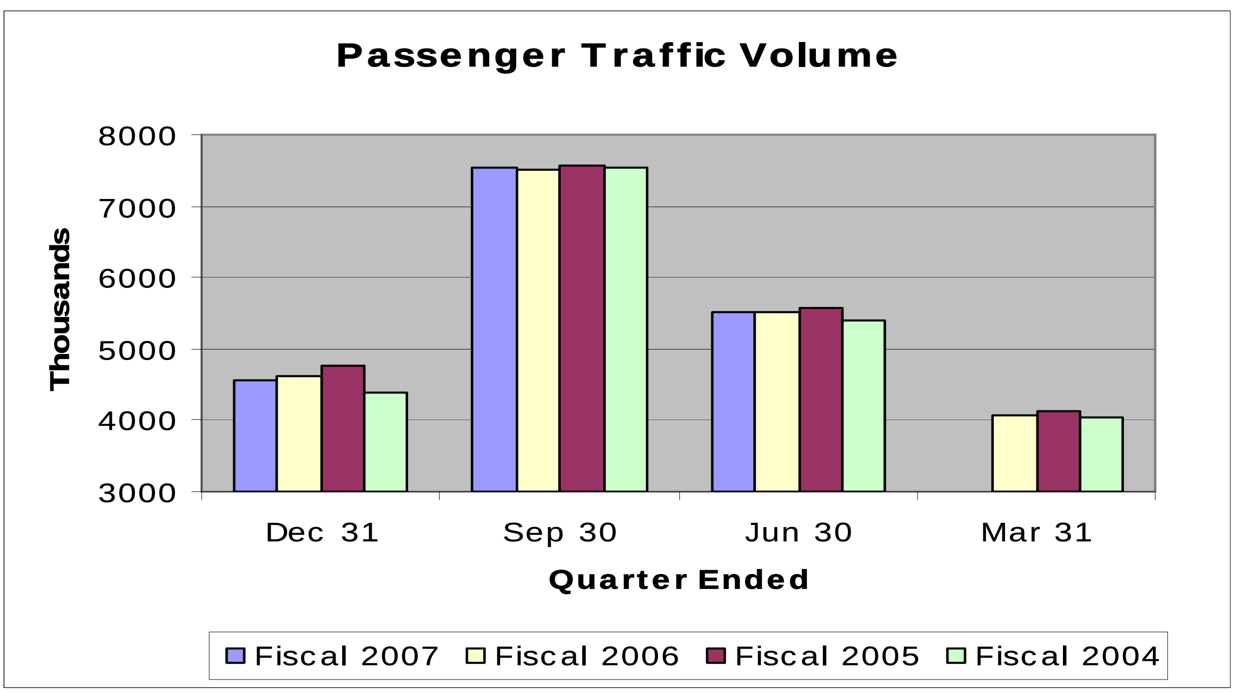
Net (loss) before extraordinary gain in the quarter ended December 2006 was $0.9 million higher than the quarter ended December 2005. Net earnings (loss) before extraordinary gain in each of the three prior quarters were better than the corresponding quarters in the previous year, ranging from $0.5 million to $7.7 million.

Total revenue in each of the latest four quarters was higher than the corresponding quarters 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. 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 over the first performance term.

Vehicle traffic decreased 0.9% in the quarter ended December 2006 compared to the quarter ended December 2005 mainly as a result of severe storm conditions. The quarter ended June 2006 was marginally lower than the quarter ended June 2005. In the quarters ended March 2006 and September 2006, we experienced a modest increase from the corresponding quarters in the previous year, resulting in a net four-quarter decrease of 0.1%. We believe that the fluctuations in traffic levels are primarily due to severe weather conditions, changes in levels of tourism and the loss of the *Queen of the North*. The following graph shows the relationship of the quarters over the past few years.



Passenger traffic in the quarter ended December 2006 was 1.4% lower than the quarter ended December 2005 mainly as a result of severe storm conditions. Passenger traffic in the quarters ended September 2006 and June 2006 increased 0.2% over the corresponding quarter in the previous year. Passenger traffic in the quarter ended March 2006 was marginally lower than the quarter ended March 2005. The average decrease of the latest four quarters was 0.5%. We believe the fluctuations in passenger traffic are primarily due to severe weather conditions, changes in levels of tourism, and the loss of the *Queen of the North*. Following is a graph showing the relationship of the quarters over the past few years.



OUTLOOK

Traffic

Ferry traffic levels are affected by a number of factors including transportation costs, the value of the Canadian dollar, weather, global security, levels of tourism, disposable personal income, the local economy and population growth. Overall, traffic levels for this fiscal year, until the end of October, were showing a moderate increase despite the implementation of three fuel surcharges and the loss of capacity on our Northern routes. In late November and through December we experienced an unprecedented number of severe wind and snow storms resulting in significantly lower volume this year compared to the prior year. As a result, we have reduced our previous expectations of vehicle and passenger traffic for this fiscal year. We now expect vehicle traffic volumes to be marginally lower than fiscal 2006 and passenger traffic volumes to be marginally higher than fiscal 2006. With the introduction of the new *Northern Adventure* into service in the spring of 2007, we anticipate traffic on our northern routes to return to former levels. Over the next few years, we anticipate modest traffic volume increases on all our routes.

Market Growth

Notwithstanding the pressure on traffic volumes, we see some opportunities for growth.

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.

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. Over the five year period ending March 2011, we expect to spend over $1.3 billion, which includes bringing eight new vessels into service. 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 decrease in our future earnings.

Regulation

Transport Canada regulates safety on our vessels by authority of the *Canada Shipping Act*. The revised Act (CSA 2001) and associated regulations are expected to come into force in the near future. At present, the impact of the revised regulations on the useful life of some of our vessels and/or the requirement for vessel upgrades is not well defined. We will address this changing regulatory environment through our planning processes and asset renewal initiatives as information becomes available. As always, the safety and security of our customers and employees remains our highest priority.

Our tariffs are regulated and our service levels are monitored by the British Columbia Ferries Commissioner. The Commissioner regulates our tariffs by establishing price caps over a performance term. Our first performance term ends March 31, 2008. We have provided the Commissioner with the information required under the *Coastal Ferry Act* to assist the Commissioner in setting price caps for the next performance term. The second performance term ends March 31, 2012.

In 2001, the federal government enacted the Marine Transportation Security Act. Initially, the legislation and the associated regulations were limited to international ports and vessels. However, in November 2005, the federal government announced that the regulations would be extended to include domestic marine services, including domestic ferries. The regulations are expected to get first gazette reading in the spring of 2007.

To comply with the regulations, all ferry operators will be required to make considerable security investments in the areas of fencing, cameras, better access controls and screening. We are in the process of defining the capital requirements and operating costs to comply with the upcoming regulations. This process is not expected to be completed until March 2007. We intend to apply for Federal funding to help offset these costs.

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 during February 2007. We also expect to issue a Request for Proposals regarding the operation of our four routes north of Port Hardy however, the timing of this request is uncertain.

FINANCIAL INSTRUMENTS

Fair market value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates cannot be determined with precision as they are subjective in nature and involve uncertainties and matters of judgment.

Derivatives

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, 2006.

	December 31, 2006				March 31, 2006	
($ millions)	Number of swaps	Term to maturity (years)	Carrying Value ($ millions)	Fair Value	Carrying Value ($ millions)	Fair Value
Commodity Fixed Price Swaps	4	Up to .5	(0.5)	(0.5)	0.9	0.9
Foreign Exchange Forward Transactions (Super C vessels)	25	Up to 1.5	0.0	(19.7)	0.0	(45.3)
Foreign Exchange Forward Transactions (Northern Expedition)	6	Up to 2.5	(2.8)	8.2	0.0	0.0

The commodity derivatives fair value reflects only the value of the commodity derivatives and not the offsetting change in value of the underlying future purchase of fuel. These fair values reflect the estimated amounts that we would receive or pay should the derivative contracts be terminated at the stated dates. Any gains or losses related to fuel commodity swaps are charged to our deferred fuel cost accounts. At December 31, 2006 we have recorded a payable of $0.5 million as the estimated loss to terminate the contracts as at this date.

The foreign exchange derivative fair 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 derivative contracts at the stated dates. The derivatives relating to the Super C vessels contract are accounted for using hedge accounting and therefore estimated gains and losses are not recorded in our financial statements. The derivatives relating to the Northern Expedition were entered into in August 2006. These are accounted for using hedge accounting commencing October 16, 2006 when appropriate documentation was completed. Any gains or losses related to these foreign exchange forward contracts are charged to our regulatory asset accounts. At December 31, 2006 we have recorded a payable of $2.8 million as the estimated market value of the loss to terminate the contracts as at October 16, 2006, after which time hedge accounting was applied.

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 believe it to be unlikely that any counterparties will 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 on pages 22 through 26 of our fiscal 2006 annual Management's Discussion and Analysis. Our risk profile is substantially unchanged during the nine months ended December 31, 2006.

In July 2006, we commissioned former BC Auditor General, George L. Morfitt to conduct an independent review of our safety policies, procedures and practices. The report resulting from this comprehensive safety review was received in January 2007. The report, which makes 41 recommendations on safety enhancements, states the following conclusion in its summary overview:

"*We concluded from our review that, overall, the company is operating a safe coastal ferry transportation system. The company directors, management and staff are highly committed to operational safety, both for the travelling public and for BC Ferries personnel. Nevertheless, there are a number of areas identified in this report where safety and related administrative processes and procedures should be strengthened.*"

We plan to implement all of the various recommendations in the report. We also plan to conduct a similar comprehensive operational safety review at a minimum of every five years as part of our ongoing commitment to ensuring the safety of our passengers and employees.

A copy of the report is available on our website at www.bcferries.com/news/files/07-008moriftt_safety_review.pdf

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 December 31, 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.