Management's Discussion & Analysis
of Financial Condition and Results of Operations
For the three months ended June 30, 2007
Dated August 2, 2007

The following is our discussion and analysis of the financial condition and results of operations for British Columbia Ferry Services Inc. (BC Ferries) as of August 2, 2007. This should be read in conjunction with our unaudited interim consolidated financial statements and related notes for the three month periods ended June 30, 2007 and 2006, and our annual audited consolidated financial statements and related notes together with our fiscal 2007 Management's Discussion & Analysis. These documents are available on SEDAR 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. 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, 2007 (the first quarter of fiscal 2008), we provided more than 44,000 sailings, carrying over 5.5 million passengers and 2.1 million vehicles.

Significant events during or subsequent to our first quarter of fiscal 2008:

- On June 14, 2007, our customs duties remission request relating to the purchase of a two-year-old vessel to replace the *Queen of the North* was approved by the federal government. The vessel, the *Northern Adventure*, underwent significant modifications and is currently in service on our northern routes. As a result of this approval, we expect to receive a refund of customs duties and related GST of approximately $13.9 million. This has been recorded as a receivable at June 30, 2007 and applied as a reduction to the cost of the vessel. In accordance with the Coastal Ferry Services Contract, the receipt of the customs duties remission will result in a reduction in future provincial northern service fees;
- On June 27, 2007, the *Queen of Alberni*, which usually operates on our Duke Point–Tsawwassen route, returned to service following an extensive $38 million upgrade that will prepare it for another 20 years of service. See "Investing in our Capital Assets" below for more detail.

FINANCIAL AND OPERATIONAL OVERVIEW
This section provides an overview of our financial and operational performance for the three months ended June 30, 2007 compared to the three months ended June 30, 2006.

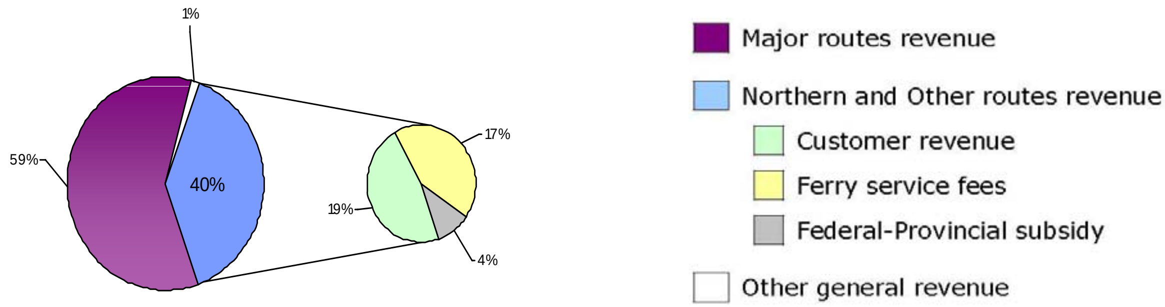
	Three months ended June 30			
($millions)	2007	2006	Variance	Variance
Total revenue	159.8	146.4	13.4	9.2%
Expenses	(137.7)	(126.1)	(11.6)	(9.2%)
Earnings from operations	22.1	20.3	1.8	8.9%
Interest and other	(7.7)	(5.4)	(2.3)	(42.6%)
Net earnings before extraordinary gain	14.4	14.9	(0.5)	(3.4)%
Extraordinary gain	-	61.3	(61.3)	
Net earnings	14.4	76.2	(61.8)	

Our consolidated net earnings in the three months ended June 30, 2007 were $0.5 million lower than net earnings before extraordinary gain in the previous year. In the prior year, we recorded an extraordinary gain of $61.3 million as a result of insurance proceeds resulting from the loss of the *Queen of the North.* See "Northern Service" below for more detail.

Revenue
Our total revenues have increased in the three months ended June 30, 2007, as shown in the table below.

Revenue ($millions)	Three months ended June 30		Increase	
	2007	2006		
Direct Route Revenue				
Vehicle traffic (volume)	2,191,013	2,187,977	3,036	0.1%
Vehicle tariff	60.4	56.3	4.1	7.3%
Passenger traffic (volume)	5,538,928	5,526,869	12,059	0.2%
Passenger tariff	34.6	33.3	1.3	3.9%
Social program fees	4.7	4.0	0.7	17.5%
Catering & on-board	19.3	17.3	2.0	11.6%
Other revenue	5.4	4.9	0.5	10.2%
Total Customer Revenue	124.4	115.8	8.6	7.4%
Indirect Route Revenue				
Ferry service fees	26.5	23.1	3.4	14.7%
Federal-Provincial subsidy	6.5	6.3	0.2	3.2%
Total Route Revenue	157.4	145.2	12.2	8.4%
Other general revenue	2.4	1.2	1.2	100.0%
Total Revenue	159.8	146.4	13.4	9.2%

Our largest revenue source is vehicle and passenger tariffs. The annual average tariff rate increase was 2.8% on our three major routes and 4.4% on the remaining routes, as permitted by the *Coastal Ferry Act*. From time to time, we utilize promotional fare reductions designed to stimulate growth in traffic levels or shift traffic away from our busiest sailings.



During the quarter, the greatest portion of our revenues, 59%, was earned on our three major routes connecting Vancouver Island to the Lower Mainland and Vancouver. The revenue from the northern and other routes makes up 40%, while other general revenue consisting of marketing rights, advertising revenues, interest earned and net foreign exchange gains is only 1% of the total revenue.

The major routes revenue is entirely direct revenue from customers and related social program fees and includes no service fees. The revenue from our northern and other routes consists of 19% from customers and related social program fees, 17% from ferry service fees and 4% from payments under the Federal-Provincial subsidy agreement. The revenue from ferry service fees has increased 2% from fiscal 2007. This is a reflection of the increase resulting from the deployment of the new *Northern Adventure* on our northern routes. See “Northern Service” below for more detail.

Changes for the three months ended June 30, 2007 and June 30, 2006 for major and northern and other routes are discussed separately below.

Comparison of Revenues for the three months ended June 30
Major Routes

Direct Route Revenue ($000s)	Three months ended June 30			
	2007	2006	Increase	
Vehicle traffic (volume)	997,778	969,927	27,851	2.9%
Vehicle tariff	45,924	42,865	3,059	7.1%
Passenger traffic (volume)	2,865,283	2,819,300	45,983	1.6%
Passenger tariff	25,659	25,155	504	2.0%
Social program fees	2,401	2,101	300	14.3%
Catering & on-board	16,026	14,398	1,628	11.3%
Reservation fees	3,240	2,970	270	9.1%
Parking	742	714	28	3.9%
Assured loading	609	507	102	20.1%
Other revenue	189	175	14	8.0%
Total Direct Route Revenue	94,790	88,885	5,905	6.6%
Gross margin – catering & on-board	10,014	8,745	1,269	14.5%

On our major routes, both vehicle traffic and passenger traffic increased over the prior year.

The increase in average tariff per vehicle was $1.83 while the average tariff per passenger was virtually unchanged. The increased traffic and higher average fares resulted in a total increase of $3.6 million in tariff revenue.

Social program fees are reimbursements from the Province of discounts provided on fares for BC seniors, students traveling to and from school, persons with disabilities and persons travelling under the medical Travel Assistance Program. These fees have increased as a result of higher program usage and higher fares.

All of our vessels that provide service on our major routes have a gift shop and options for food service. Food sales increased $1.1 million as a result of higher spending per passenger and the higher number of passengers carried. Gift shop sales increased $0.3 million with significant improvements in sales of books, clothing and giftware. We have achieved higher sales while increasing margins.

Fees for reservations, parking commissions and surcharges from assured loading ticket sales also show a marked increase as a result of both increased prices and increased usage.

Northern Routes

Direct Route Revenue	Three months ended June 30			
($000s)	2007	2006	Increase (Decrease)	
Vehicle traffic (volume)	8,107	5,848	2,259	38.6%
Vehicle tariff	1,750	1,295	455	35.1%
Passenger traffic (volume)	23,325	16,583	6,742	40.7%
Passenger tariff	1,434	983	451	45.9%
Social program fees	130	90	40	44.4%
Catering & on-board	538	298	240	80.5%
Reservation fees	19	7	12	171.4%
Stateroom rental	179	76	103	135.5%
Parking	9	6	3	50.0%
Hostling	45	40	5	12.5%
Other revenue	3	6	(3)	(50.0%)
Total Direct Route Revenue	4,107	2,801	1,306	46.6%
Indirect Revenue				
Ferry service fees	7,196	3,794	3,402	89.7%
Federal-Provincial subsidy	1,097	1,074	23	2.1%
Total Route Revenue	12,400	7,669	4,731	61.7%
Gross margin - catering & on-board	235	127	108	85.0%

Our northern routes consist of three regulated routes operating on the British Columbia coast north of Port Hardy on Vancouver Island. Traffic levels have steadily increased since the resumption of full service, but have not yet reached the levels experienced prior to the loss of the *Queen of the North*.

The average tariff per vehicle decreased $5.58 due to the proportionately greater number of passenger vehicles with the resumption of full service this year, as compared to commercial and other larger vehicles which attract higher fares. The average passenger tariff increase was $2.20. The increased traffic and higher average passenger fares, partially offset by lower average vehicle fares, resulted in a total tariff revenue increase of $0.9 million.

We receive ferry service fees for these routes under the Coastal Ferry Services Contract. The increase in fees reflects the negotiated increase resulting from the deployment of the *Northern Adventure*, which commenced operations on March 31, 2007.

Reimbursements from the Province for social program fees increased as a result of higher program usage and higher fares.

The increase in catering and on-board revenue and stateroom revenue resulted from the resumption of regular service. Other increases in catering and onboard revenue resulted from higher food and gift shop sales per passenger. Fees for reservations, parking commissions and hostling have increased as a result of higher usage and higher rates.

Other Routes

Direct Route Revenue	Three months ended June 30			
($000s)	2007	2006	Increase (Decrease)	
Vehicle traffic (volume)	1,185,128	1,212,202	(27,074)	(2.2%)
Vehicle tariff	12,761	12,109	652	5.4%
Passenger traffic (volume)	2,650,320	2,690,986	(40,666)	(1.5%)
Passenger tariff	7,535	7,178	357	5.0%
Social program fees	2,137	1,773	364	20.5%
Catering & on-board	2,731	2,569	162	6.3%
Reservation fees	317	296	21	7.1%
Stateroom rental	3	2	1	50.0%
Parking	62	60	2	3.3%
Other revenue	10	95	(85)	(89.5%)
Total Direct Route Revenue	25,556	24,082	1,474	6.1%
Indirect Revenue				
Ferry service fees	19,336	19,348	(12)	(0.1%)
Federal-Provincial subsidy	5,367	5,253	114	2.2%
Total Route Revenue	50,259	48,683	1,576	3.2%
Gross margin - catering & on-board	1,743	1,553	190	12.2%

Our other routes consist of 19 regulated routes and eight small unregulated routes primarily serving northern and southern Gulf Islands and the Sunshine Coast. One of the regulated routes, as well as all of the unregulated routes, are operated under contract by alternative service providers. We receive fees from the Province for the provision of service on the unregulated routes, which are included in the ferry service fees in the above table.

More than 38% of the vehicle traffic decrease and 50% of the passenger traffic decrease was as a result of suspended service for almost two months on our Mill Bay-Brentwood Bay route. The vessel servicing this route is removed from service every four years for a major refit. This year, additional steel replacement work was required on the 50-year-old vessel.

The increase in average tariff per vehicle was $0.78 while the average passenger tariff increase was $0.18. The increased average fares, partially offset by the reduction in traffic levels, resulted in a total tariff revenue increase of $1.0 million.

Reimbursements from the Province for social program fees increased as a result of higher program usage and higher fares.

Increases in catering and onboard revenue resulted from higher food and gift shop sales per passenger and additional sales from an expanded gift shop on the *Queen of Surrey*, which operates between Horseshoe Bay and Langdale.

Fees for reservations and parking commissions have increased as a result of higher usage and higher rates. The decrease in other income is mainly a result of additional revenue from charters in the prior year.

Expenses

Expenses for the three months ended June 30, 2007 and 2006 are summarized in the table below.

	Three months ended June 30			
($ millions)	2007	2006	(Increase)Decrease	
Operations	81.9	75.7	(6.2)	(8.2%)
Maintenance	21.4	17.9	(3.5)	(19.6%)
Administration	11.2	12.6	1.4	11.1%
Cost of retail goods sold	7.3	6.9	(0.4)	(5.8%)
Amortization	15.9	13.0	(2.9)	(22.3%)
	137.7	126.1	(11.6)	(9.2%)
Interest & other	7.7	5.4	(2.3)	(42.6%)
Total expense	145.4	131.5	(13.9)	(10.6%)

The $6.2 million increase in operations expenses reflects:

- $6.3 million increase in wages and benefits, including wage rate increases averaging approximately 4%; $1.5 million additional wages on our northern routes reflecting the full service offered this quarter; $1.5 million in increased training and overtime costs; and $1.4 million in increased benefit costs;
- $1.1 million increase in fuel expense. With the addition of the *Northern Adventure*, we had full service on the northern routes in this quarter causing a $0.9 increase in fuel year-over-year. The balance results from the increase in set prices of 1.86% as ordered by the British Columbia Ferries Commissioner (see “Fuel Deferral and Related Surcharge” below); and
- $1.2 million decrease in external services relating to costs incurred in the prior year that related to the replacement service provided following the loss of the *Queen of the North*.

Maintenance expenses for vessel refit and maintenance were $3.0 million higher and costs relating to terminal maintenance activities were $0.5 million higher. These increases reflect our aging fleet and our continued commitment to safety.

Administration expenses decreased $1.4 million partially as a result of $0.7 million lower use of contracted services and $0.5 million lower information technology fees and licensing costs.

Amortization increased a total of $2.9 million as a result of additional assets coming into service including $1.5 million reflecting the *Northern Adventure* entering service in March 2007.

Interest expenses increased $2.3 million due to $3.1 million additional interest relating to our third $250 million bond series issued in March 2007, partially offset by $0.8 million of additional interest capitalized reflecting our investment in revitalizing our fleet and terminal facilities.

Fuel Deferral and Related Surcharge

In September 2004, the British Columbia Ferries Commissioner (the Commissioner) issued an order authorizing our use of deferred fuel cost accounts to mitigate the effect on earnings of volatility in fuel oil prices.

The Commissioner established set prices for fuel oil for each of the years until March 31, 2008. At the start of each fiscal year in the first performance term, the set prices increase by the Consumer Price Index (Vancouver). The increase, effective April 1, 2007, was 1.86%.

On March 30, 2007, the Commissioner proposed the continued use of inflation-adjusted set prices and deferred fuel cost accounts for the second performance term.

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.

In order to reduce or eliminate these increasing deferred fuel cost account balances, extraordinary price cap increases were approved by the Commissioner and fuel surcharges were implemented beginning in July 2005. On June 1, 2007 adjustments were made to these fuel surcharges on two routes. The deferred fuel cost account balance on the Horseshoe Bay-Langdale route was low enough to allow a reduction in the fuel surcharge. The deferred fuel cost account on the Mill Bay–Brentwood Bay route reflected a surplus position and the fuel surcharge was removed and a rebate was implemented on this route.

The balances in our deferred fuel cost accounts totalled $18.3 million at June 30, 2007 ($18.8 million at March 31, 2007).

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

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. An extensive monitoring program has determined that the level of contaminants is very low in edible organisms, including shellfish, in the area of the wreck and that there is no risk for human consumption. The feasibility and risk of recovering any fuel and lubricants that may remain in the vessel has been investigated. The Canadian Coast Guard conclusions are that a significant amount of the fuel and lubricants were released following the incident, a recovery operation would be exploratory at best, and it is probable that there is no recoverable fuel remaining on the vessel. As a result, we have determined not to pursue fuel and lubricant recovery from the incident site. We will continue to monitor the site for leakage.

Our divisional inquiry, released March 26, 2007, concluded that human factors were the primary cause of the incident, but noted that the activities on the bridge during the last fourteen minutes before the grounding were unknown. Subsequently, additional information has been obtained and our divisional inquiry has been reconvened. A report is expected to be released shortly. The Transportation Safety Board and the RCMP investigations are ongoing.

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. We reported an extraordinary gain of $61.3 million for this event in the first quarter of fiscal 2007. These funds were utilized to partially fund the acquisition of the *Northern Adventure.* 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.

In March 2007, the *Northern Adventure*, a replacement for the *Queen of the North*, went into service on our northern routes. The two-year-old vessel was purchased in October 2006 and underwent significant modifications 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 74 state rooms and will accommodate more than 600 passengers and 101 vehicles. With the deployment of this new vessel, the service fees from the Province have increased approximately $11 million annually, beginning April 1, 2007.

In August 2006, we signed a $133 million contract with Flensburger Schiffbau-Gesellschaft (FSG) of Germany to build the *Northern Expedition* to replace the 41-year-old *Queen of Prince Rupert* currently operating on our northern routes. 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. See "Investing in our Capital Assets" below for more detail. With the deployment of this new vessel, the service fees from the Province will increase approximately $22 million annually upon the vessel's entry into service.

We anticipate a third replacement vessel for the northern service will be acquired and commence operating during our next performance term. Negotiations with the Provincial government for increased service fees with respect to this vessel are ongoing.

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 five years, 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, 2007.

In March 2007 we closed a $250 million senior secured bond issue, Series 07-1, due March 20, 2037, bearing interest at 5.021%, payable semi-annually. The net proceeds were used primarily to repay our credit facility, fund capital expenditures and the Series 07-1 debt service reserve and for general corporate purposes as planned.

During the quarter, we negotiated an amendment to our $155 million five year revolving credit facility maturing May 12, 2012, that provides us with an option to request a one year extension annually. There are no draws on this facility at June 30, 2007.

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 months ended June 30, 2007 and 2006 are summarized in the table below.

	Three months ended June 30	
($ millions)	2007	2006
Net income before extraordinary gain	14.4	14.9
Extraordinary gain	-	61.3
Items not involving cash:		
Amortization	15.8	13.0
Other non-cash charges	0.1	0.2
Regulatory costs deferred	0.5	(1.2)
Change in operating working capital	(11.2)	(30.7)
Cash provided by operating activities	19.6	57.5
Cash used by financing activities	(24.8)	(0.1)
Cash used in investing activities	(74.7)	(31.9)
Total decrease in cash	(79.9)	25.5

Cash provided by operating activities includes an increase in non-cash working capital of $11.2 million for the first quarter of fiscal 2008. This increase was primarily due to:

- $12.0 million decrease in payables and accrued liabilities relating to refit and maintenance and other operating activities;

- $6.7 million increase in prepaid expenses primarily due to a $2.6 million increase in property taxes; and $0.9 increase in insurance and a $0.5 million increase in contracts as a result of annual remittances made in the first quarter and a $2.7 million seasonal increase in fuel;
- $4.6 million decrease in interest payable due to $15.0 million in bond interest payments made, partially offset by accrued interest on three bond series (third bond Series 07-1 issued in March 2007); and
- $0.1 net increase in inventories.

The working capital increase was partially offset by:

- $5.5 million decrease in accounts receivable resulting from receipt of $6.2 million in ferry service fees, $1.5 million in property tax refunds, $1.9 million in structured financing facility funds, and $0.8 million insurance proceeds for third party claims, all set up as receivables at March 31, 2007. These receipts were partially offset by increases of $2.2 million in social program fees recoverable reflecting higher program usage and two months of receivable (one month at March 31, 2007) and $2.7 million in commercial travel card receivables as a result of change in payment terms of net 7 to net 30 days;
- $4.3 million increase in deferred revenue as a result of a $3.6 million increase in reservations, reflecting the seasonal nature of our traffic patterns; a $0.5 million increase in commuter tickets; and a $0.5 million increase in assured loading tickets; partially offset by a $0.3 million reduction in deferred advertising representing three months of advertising income; and
- $2.3 million increase in current regulatory liabilities reflecting $2.1 million in tariff revenues collected in excess of the price cap on the major routes and $0.1 million on the other routes in the first quarter of fiscal 2008. We expect to return these excess collections to customers during the second quarter; and
- $0.1 million increase in accrued employee costs.

Cash used in financing activities reflects the repayment of our short-term borrowings with proceeds from the $250 million, Series 07-1 bond issued in March 2007.

Cash used in investing activities consists of an $11.1 million investment in short term investments and $63.6 million in capital expenditures. The significant capital transactions in this quarter are described below in "Investing in Our Capital Assets".

Investing in our Capital Assets

Capital expenditures in the first quarter of fiscal 2008 totalled $33.9 million (on an accrual basis). This level of expenditure reflects significant investments in our fleet, terminals and information systems to increase customer service and operating efficiency. Expenditures for the first quarter included:

- $23.0 million in new vessels, vessel upgrades and modifications including:
  - $18.1 million of the $542 million Super C-class new vessel construction project;
  - $10.3 million of the $38 million mid-life upgrade to the *Queen of Alberni* that included safety, structural and mechanical improvements;
  - $2.4 million of the $200 million project for the construction of the new *Northern Expedition*; and
  - $2.3 million of the $24 million for upgrade and replacement of propulsion and safety equipment on the *Quinsam*, the *Quinitsa* and the *Queen of Capilano*;
  - These additions were partially offset by $13.9 million in customs duties remission relating to the purchase of the *Northern Adventure.* Our application for remission has been approved by the federal government and the expected refund of customs duties and related GST has been recorded as a receivable at June 30, 2007 and applied to reduce the cost of the vessel;

- $6.9 million in marine structures, including:
  - $2.3 million of a $14 million project that completes upgrades to the berths and $1.0 million of electrical upgrades at Departure Bay terminal; and
  - $2.1 million of a $12 million project to upgrade the berths at Horseshoe Bay terminal;
- $3.3 million in terminal and building upgrades and equipment, including $1.6 million at Swartz Bay, $0.7 million at Departure Bay and $0.6 million at Alert Bay terminals; and
- $0.6 million in computer hardware and software development to improve operational data capture and reporting, time collection and security of customer credit card information.

Major Vessel Upgrades

The *Queen of Alberni*, which usually operates on our Duke Point–Tsawwassen route, returned to service on June 27, 2007, following an extensive $38-million upgrade. The 31-year-old vessel underwent significant upgrades to prepare for another 20 years of service. The upgrades included safety and mechanical improvements as well as improved and expanded passenger amenities. The *Queen of Alberni* is the fifth, and final, C-class vessel to undergo such a major mid-life upgrade. Similar upgrades have already been undertaken on the *Queen of Coquitlam*, *Queen of Cowichan, Queen of Surrey* and *Queen of Oak Bay.*

Coastal Renaissance, Coastal Inspiration and Coastal Celebration

In September 2004 we entered into contracts with FSG to build three new Super C-class vessels that will be the largest double-ended vessels in the world. Each vessel will measure 160-metres in length and will have a capacity of 1,650 passengers and 370 vehicles. The contracts are design-build and fixed price, 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 customs duties 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 customs duties, but 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.

Construction of the *Coastal Renaissance* started in August 2006, and the vessel was launched in Germany in April 2007. Construction of the *Coastal Inspiration* commenced in November 2006 with construction of the *Coastal Celebration* beginning in April 2007. These new vessels will replace aging vessels that currently provide service on our major routes. The *Coastal Renaissance* is expected to be in service in early 2008. 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.

These three new vessels will sail from Germany wrapped with an invitation to the 2010 Olympic and Paralympic Winter Games. Each will feature four photographic images and branding colours promoting the Games and the beauty of our province. The wrapped ferries will journey home starting this fall with promotional stops in London, Los Angeles, San Francisco and Seattle to raise awareness for the Games and to promote British Columbia as a tourist destination. We are collaborating with the Vancouver Organizing Committee for the 2010 Olympic and Paralympic Winter Games and 3M Canada to design and create these decals, the largest marine application of printed graphics ever undertaken.

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 41-year-old *Queen of Prince Rupert* currently operating on our northern routes. The customs duties and taxes on this contract will total approximately $43 million. We will be seeking a remission of the customs duties, but 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.

New Intermediate Vessel

In December 2006, the keel was laid for a 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 47-year-old *Queen of Tsawwassen*. 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. The contract provides for delivery of this vessel in time for it to enter service by the summer of 2008.

Terminal Marine Structures

As we reinvest in our terminal infrastructure and prepare for the arrival of the new Super C-class vessels, significant upgrades are underway at many of our terminals. Over the next five years, we plan to invest $237 million in our terminals for building and marine structure upgrades.

To accommodate the Super C-class vessels, modifications of marine structures at one berth at Departure Bay terminal are substantially complete, and work is continuing on other berths. Modifications at Horseshoe Bay terminal are underway. These berth upgrades, expected to be complete in the fall of 2007, include new trestles, dolphins[1] and catwalks. A new state-of-the-art berth was completed at our Swartz Bay terminal in fiscal 2007.

Besides upgrades to accommodate the Super Cs, many upgrades are underway to provide better service to our customers and improve operational efficiencies. Upgrades at Alert Bay terminal are also underway to construct a building to house a waiting room with washrooms, reinforce the eroding bank area and upgrade the electrical service.

Information Technology

We are currently implementing a system to capture and report operational data in a more timely and accurate manner. This system was installed at several of our terminals during the first quarter of fiscal 2008, with the remaining locations expected to receive the new system this summer.

Also, to improve fleet safety, we are installing Voyage Data Recorders (VDRs) on all the vessels in the fleet. A VDR is an electronic data collection system which records and securely stores voyage information from the navigation equipment, propulsion control systems, radio communications, voice audio and bridge ambient sounds. They have been installed on the *Spirit of Vancouver Island*, *Queen of Surrey*, *Queen of Capilano*, *Northern Adventure*, *Kuper* and *Queen of Burnaby*. Our intention is for the entire fleet to have VDRs fitted by October 2008 and all new construction vessels will be fitted during construction.

Other ongoing projects include a new time collection system, enhanced reporting initiatives, enhanced crew scheduling system and replacement of obsolete technology and security projects. These projects focus on obtaining efficiencies, improving safety and security and providing better service to our customers.

[1] A cluster of pilings firmly fixed to the sea bed and used to assist vessels during docking.

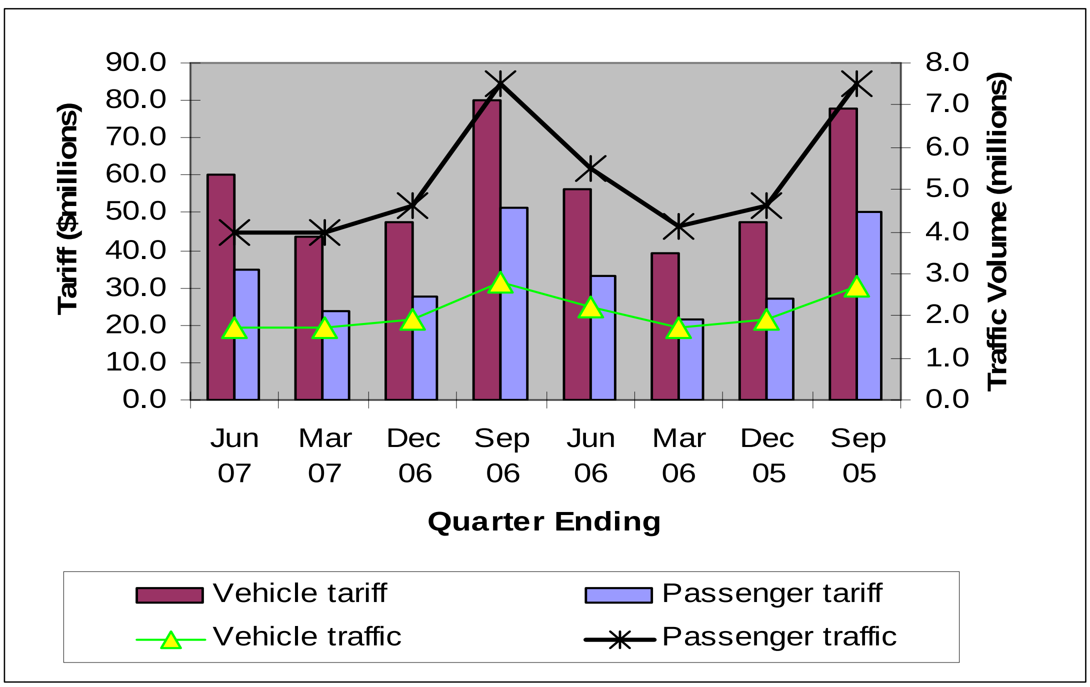
SUMMARY OF QUARTERLY RESULTS

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

	Quarter Ended (unaudited)							
($millions)	Jun 07	Mar 07	Dec 06	Sep 06	Jun 06	Mar 06	Dec 05	Sep 05
Total revenue	159.8	119.0	128.4	202.7	146.4	109.7	126.0	198.3
Earnings (loss) from operations	22.1	(27.7)	2.5	73.0	20.3	(18.7)	5.4	67.3
Net earnings (loss) before extraordinary gain	14.4	(33.2)	(1.8)	68.9	14.9	(24.8)	(0.9)	61.2
Extraordinary gain	0.0	0.0	0.0	0.0	61.3	0.0	0.0	0.0
Net earnings (loss)	14.4	(33.2)	(1.8)	68.9	76.2	(24.8)	(0.9)	61.2
Maintenance expense	21.4	31.8	21.9	13.4	17.9	28.1	21.8	13.1
Maintenance as % of total expense	16%	22%	17%	10%	14%	22%	18%	10%

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 following graph demonstrates the seasonality of our revenue and shows the relationship of traffic volume and tariff revenue over the most recent eight quarters.



OUTLOOK

Safety

The safety of the public and our employees is our highest priority.

Part of our safety plan is to increase, during fiscal 2008, the level of annual operational training we conduct from approximately 11,000 to 14,200 person days. In the first quarter, we conducted 5,955 personal training days, 70% more than the first quarter of the prior year.

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. We experienced a moderate decrease in both total passenger and total vehicle traffic in the last two fiscal years; however, over the past five years they are both trending upwards. In the first quarter of fiscal 2008, we experienced increased traffic levels on our major routes and decreased traffic levels on half of our other routes.

During the last two fiscal years, traffic levels were negatively affected by the implementation of three fuel surcharges, the loss of capacity on our northern routes and an unprecedented number of severe wind and snow storms in November and December 2006. With the introduction of the *Northern Adventure* into service in March 2007, we anticipated that traffic on our northern routes would return to former levels. Since the resumption of full service, traffic levels have not yet reached the levels experienced prior to the loss of the *Queen of the North,* but they are steadily increasing. Over the next few years, we anticipate modest traffic volume increases on all our routes.

Vehicle Traffic by fiscal year

(thousands)	2007	2006	2005	2004	2003
Major routes	3,826.5	3,790.4	3,808.8	3,688.1	3,734.4
Northern routes	25.9	37.1	37.1	37.0	37.2
Other routes	4,669.5	4,715.8	4,711.5	4,567.1	4,549.9
Total	8,521.9	8,543.3	8,557.4	8,292.2	8,321.5
Annual % (decrease) increase	(0.3%)	(0.2%)	3.2%	(0.4%)	2.7%
Five year % increase	2.4%				

Passenger Traffic by fiscal year

(thousands)	2007	2006	2005	2004	2003
Major routes	11,146.3	11,055.9	11,222.4	10,824.7	11,104.2
Northern routes	78.2	117.1	117.2	117.0	119.9
Other routes	10,440.5	10,556.6	10,686.9	10,425.7	10,400.1
Total	21,665.0	21,729.6	22,026.5	21,367.4	21,624.2
Annual % (decrease) increase	(0.3%)	(1.3%)	3.1%	(1.2%)	1.8%
Five year % increase	0.2%				

Market Growth

Notwithstanding the pressure on traffic volumes, we see 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.

In February 2007, we signed a 40-year lease with the Town of Sidney on Vancouver Island under which we will manage and develop the town's international ferry terminal. The lease recognizes Washington State Ferries as a priority user and promotes use by other operators. This provides us with an opportunity to support the community and develop innovative new business strategies.

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 are continuing with our fleet and asset renewal program. We added two new vessels to our fleet in March 2007, the *Northern Adventure* and the *Kuper*. Over the five-year period ending March 2012, we expect to spend approximately $1.2 billion, which includes bringing six new vessels into service. Upgrading and replacing a large share of our fleet through new vessel acquisitions and our revitalization program will assist in maintaining operational reliability.

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 increase. We expect this will cause a decrease in our future earnings in the near term.

Regulation
Transport Canada regulates safety on our vessels by authority of the *Canada Shipping Act*. On July 1, 2007, the *Canada Shipping Act, 2001* came into effect. This is the principal legislation governing the activities of Canadian vessels in all waters and of all vessels in Canadian waters. 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 are addressing the changing regulations through our planning processes and asset renewal initiatives as information becomes available. As always, the safety of our customers and employees remains our highest priority.

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. These regulations have been extended to include domestic marine services, including domestic ferries. We will be required to satisfy a specific level of security on our vessels and at our terminals servicing our major routes. These new domestic ferry regulations are anticipated to be announced in 2008. Considerable security investments will be required in the areas of fencing, cameras, closed circuit TV, better access controls and screening. We have developed a corporate security strategy and location-specific security plans for the majority of our terminals and vessels. Through the Marine Security Contribution Program, we are eligible for reimbursement of $3.8 million of federal funding under our first application to help offset the costs of perimeter security, access control measures and training. We anticipate making future applications to offset costs of security upgrades to vessels and terminals.

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 and our second performance term ends March 31, 2012. In March 2007, the Commissioner set preliminary price caps for the second performance term. The Province had until June 30, 2007 to determine if there were to be any changes to core service fees or core service levels in the second performance term. The resulting amendments to the Coastal Ferry Services Contract with the Province have been submitted to the Commissioner. The Commissioner has until September 30, 2007 to determine the final price caps for the second performance term.

Competition
New competitors have emerged in both the passenger-only market and 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 alternative vehicle and passenger ferry services. We remain mindful of these potential changes in the market and 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 BC Ferries, can provide a more cost-effective service offering. In February 2007, we issued a Request for Proposal on the Brentwood Bay-Mill Bay route to two proponents. The Request for Proposal closed in June 2007 and the responses received from the proponents are currently being evaluated. We expect to make a decision on whether to proceed with an alternative service provider on this route by the end of December 2007. We are also currently working with a potential alternative service provider regarding a possible pilot project for the Buckley Bay-Denman Island and Hornby Island-Denman Island routes. Additionally, we expect to issue a Request for Proposal regarding the operation of our four routes north of Port Hardy; however, the timing of this request is uncertain.

FINANCIAL INSTRUMENTS

Fair 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 three months ended June 30, 2007.

($ millions)	June 30, 2007				March 31, 2007	
	Number of swaps	Term to maturity (years)	Carrying Value Asset (Liability) ($ millions)	Fair Value	Carrying Value Asset (Liability) ($ millions)	Fair Value
Commodity Fixed Price Swaps	2	Up to .3	0.2	0.2	0.7	0.7
Foreign Exchange Forward Transactions (Super C-class vessels)	29	Up to 1.5	(42.4)	(42.4)	0.0	(18.7)
Foreign Exchange Forward Transactions (Northern Expedition)	6	Up to 1.8	1.4	1.4	(2.8)	8.6

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 June 30, 2007 we have recorded a receivable of $0.2 million as the estimated gain 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. We de-designated all previously designated hedges for hedge accounting on June 30, 2007. With the adoption of the new Handbook sections on financial instruments, all derivatives are recorded at mark to market on our balance sheet. Any gains or losses related to these foreign exchange forward contracts are charged to our regulatory accounts.

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

A discussion of enterprise wide risk management can be found in our fiscal 2007 annual Management's Discussion & Analysis. Our risk profile is substantially unchanged during the three months ended June 30, 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, 2007 and June 30, 2007 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.

Discussion of the most critical accounting policies and estimates that we have used in the preparation of our consolidated financial statements can be found on pages 27 through 30 of our fiscal 2007 Management's Discussion & Analysis. The following is a discussion of changes to critical accounting policies we have used in the preparation of our consolidated financial statements for the three months ended June 30, 2007.

Changes in Accounting Policies

Effective April 1, 2007, we adopted the Canadian Institute of Chartered Accountants (CICA) Handbook Section 1530, *Comprehensive Income*, CICA Handbook Section 3251, *Equity*, CICA Handbook Section 3855**,** *Financial Instruments – Recognition and Measurement,* CICA Handbook Section 3861, *Financial Instruments – Disclosure and Presentation*, and CICA Handbook Section 3865, *Hedges*. These new Handbook Sections provide comprehensive requirements for the recognition and measurement of financial instruments, as well as standards on when and how hedge accounting may be applied. Handbook Section 1530 also establishes standards for reporting and displaying comprehensive income. Comprehensive income is defined as the change in equity from transactions and other events from non-owner sources. Other comprehensive income refers to items recognized in comprehensive income but that are excluded from net income calculated in accordance with generally accepted accounting principles.

Under these new standards, all financial instruments are classified into one of the following five categories: held for trading, held-to-maturity investments, loans and receivables, available-for-sale financial assets or other financial liabilities. All financial instruments, including derivatives, are included on the consolidated balance sheet and are initially measured at fair value. Subsequent measurement and recognition of changes in fair value of financial instruments depends on their initial classification. Held for trading financial instruments are measured at fair value and all gains and losses are included in net income in the period in which they arise. Available-for-sale financial instruments are measured at fair value with revaluation gains and losses included in other comprehensive income until the asset is removed from the balance sheet. Loans and receivables, investments held-to-maturity and other financial liabilities are measured at amortized cost.

The standards require derivative instruments to be recorded as either assets or liabilities measured at their fair value unless exempted from derivative treatment as a normal purchase and sale. Certain derivatives embedded in other contracts must also be measured at fair value. All changes in the fair value of derivatives are recognized in earnings unless specific hedge criteria are met, which requires that a company must formally document, designate and assess the effectiveness of transactions that receive hedge accounting.

The adoption of these standards has the following effect on the consolidated financial statements for the three months ended June 30, 2007:

(a) Recognition of foreign currency forward contracts as derivative assets and liabilities in the consolidated financial statements;
(b) Restatement of opening retained earnings at April 1, 2007 to recognize the prior years' earnings effect of accounting for long-term debt using the effective interest method; and
(c) Reclassification of deferred financing costs to long-term debt.

We also de-designated all previously designated hedges on June 30, 2007 under Section 3865 – Hedges. All of these hedges, which were entered into to provide greater certainty of the cost of new vessel acquisitions denominated in foreign currency, were effective at the time of de-designation. All hedges are recorded at fair value with unrealized gains and losses recorded to the regulatory asset or liability accounts on the balance sheet.

We have no embedded derivatives that meet the requirements of Section 3855 which would require that they be separated from host contracts and valued separately at fair value.

We have not recognized any adjustments through other comprehensive income for the three months ended June 30, 2007.

The adoption of these sections is done prospectively without restatement of the consolidated financial statements of prior periods. As at April 1, 2007, the impact on the consolidated financial statements of recording foreign currency forward contracts as derivative assets and liabilities, measuring the long-term debt using the effective interest rate method and reclassifying the deferred financing costs directly attributable to the issuance of the long-term debt is summarized in the table below:

($millions)	April 1, 2007	March 31, 2007	Net Impact
Derivative assets	8.6	-	8.6
Other assets - deferred financing costs	1.0	9.5	(8.6)
Derivative liabilities	18.7	2.8	15.8
Long-term debt	740.6	749.6	(9.0)
Retained earnings	204.0	203.5	0.5

In the table above, the remaining balance of deferred financing costs at April 1, 2007 represent costs incurred for long-term debt arranged for but not yet issued.

Future Accounting Changes

We have not yet adopted the following CICA Handbook Sections:

Section 1535, *Capital Disclosures,* effective for us beginning April 1, 2008, establishes standards for disclosing information about our capital and how it is managed. The standard requires disclosures of our objectives, policies and processes for managing capital, the quantitative data about what we regard as capital, whether we have complied with any capital requirements and if we have not complied, the consequences of such non-compliance. We do not expect application of this section to have a significant impact on our consolidated financial statements.

Section 3031, *Inventory*, replacing Section 3030, effective for us beginning April 1, 2008, provides guidance on the determination of inventory cost, subsequent recognition as expense, and write-downs to net realizable value. We do not expect application of this section to have a significant impact on our consolidated financial statements.

Section 3862, *Financial Instruments – Disclosure*, effective for us beginning April 1, 2008, requires disclosures, by class of financial instrument, that enable users to evaluate the significance of financial instruments on financial position and performance, including disclosures about fair value. In addition, disclosure is required of qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about credit risk, liquidity risk, and market risk. The quantitative disclosures must also include a sensitivity analysis for each type of market risk to which an entity is exposed, showing how net earnings and other comprehensive income would have been affected by reasonably possible changes in the relevant risk variable.

Section 3863, *Financial Instruments – Presentation*, effective for us beginning April 1, 2008, carries forward existing requirements on presentation of financial instruments. We do not expect application of this section to have any impact on our consolidated financial statements.

SYSTEMS, PROCEDURES AND CONTROLS

We are responsible for establishing and maintaining disclosure controls and procedures to ensure that material information is recorded, processed, summarized and reported as required by applicable Canadian securities legislation. We have carried out an evaluation of the effectiveness as of June 30, 2007 of the design and operation of the disclosure controls and procedures. Based on this evaluation, the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) concluded that the disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed to satisfy continuous disclosure obligations and are effective in ensuring that information required to be disclosed is accumulated and communicated as appropriate to allow timely decisions regarding required disclosure.

We are responsible for designing and implementing internal controls over financial reporting to provide reasonable assurance regarding the reliability of the reporting and the preparation of consolidated financial statements for external purposes in accordance with Canadian generally accepted accounting principles. We have carried out a review of our internal controls over financial reporting as of June 30, 2007. Based on this evaluation, the CEO and CFO concluded that such internal controls have been designed to provide reasonable assurance regarding the reliability of the reporting and the preparation of consolidated financial statements for external purposes. There were no changes in internal control over financial reporting that occurred during the first quarter of fiscal 2008 that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

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.