

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

**For the three and nine months ended December 31, 2007
Dated January 31, 2008**

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**Management's Discussion & Analysis
of Financial Condition and Results of Operations
For the three and nine months ended December 31, 2007
Dated January 31, 2008**

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 January 31, 2008. 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, 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 December 31, 2007 (the third quarter of fiscal 2008), we provided more than 45,000 sailings, carrying 4.6 million passengers and 1.9 million vehicles.

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

- On November 20, 2007, the hull of the *Island Sky*, our new intermediate class ferry, was launched and subsequently towed to Victoria Shipyards where the superstructure will be loaded onto the vessel. The *Island Sky* will allow for the retirement of the 48-year-old *Queen of Tsawwassen*. A \$45.5 million contract with Vancouver Shipyards constitutes the majority of the total project budget of \$57 million. See "Investing in our Capital Assets" below for more detail.
- In December 2007, the vessel design for the new *Northern Expedition* was completed and assembly of the first superstructure modules began. The *Northern Expedition* is expected to replace the 41-year-old *Queen of Prince Rupert*, 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. The total project budget for this vessel is \$200 million. See "Investing in our Capital Assets" below for more detail.

- On December 13, 2007, the first of three new Super C-class vessels, the *Coastal Renaissance*, arrived in British Columbia following a 48-day, 9,990 nautical mile journey from Germany. Crew training and familiarization in the operation of this brand new state-of-the-art vessel is currently underway. The *Coastal Renaissance* is expected to enter service on the Departure Bay–Horseshoe Bay route in March 2008.

The second Super C-class vessel, the *Coastal Inspiration*, is expected to depart Germany for the trans-Atlantic voyage to British Columbia in February. The vessel is scheduled to enter service on the Duke Point-Tsawwassen route by the summer of 2008.

On December 14, 2007, the third and final Super C-class vessel, the *Coastal Celebration*, was officially launched at Flensburger Schiffbau-Gesellschaft (FSG) of Germany, with completion expected in May 2008. The *Coastal Celebration* is expected to be in service on the Swartz Bay-Tsawwassen route by the fall of 2008.

These vessels are the largest double-ended ferries in the world, with each vessel measuring 160 metres in length and having a capacity of 1,650 passengers and crew and 370 vehicles. They feature a diesel-electric propulsion system/power station that is one of the largest and most economical of its kind in the world. These new ships will replace aging vessels which currently provide service on our major routes. The total budget for the three vessels is \$542 million. The project is currently on schedule and under budget. See “Investing in our Capital Assets” below for more detail.

- On January 11, 2008, we closed a \$200 million senior secured bond issue by private placement. The net proceeds will be used to repay our credit facility, fund capital expenditures and the Series 08-1 debt service reserve fund and for general corporate purposes. See “Liquidity and Capital Resources” below for more detail.

FINANCIAL AND OPERATIONAL OVERVIEW

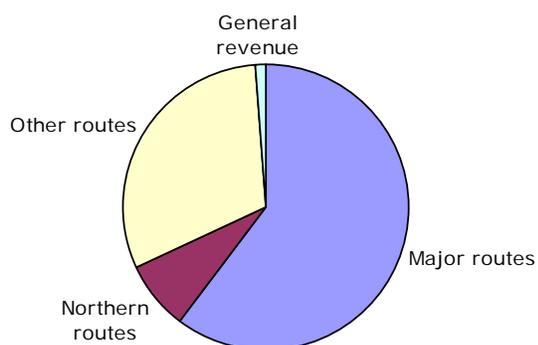
This section provides an overview of our financial and operational performance for the three and nine months (year-to-date) ended December 31, 2007 and 2006.

(\$ millions)	Three Months Ended December 31			Nine Months Ended December 31		
	2007	2006	Variance	2007	2006	Variance
Total revenue	136.5	128.5	8.0	516.5	477.8	38.7
Expenses	(136.9)	(125.9)	(11.0)	(425.4)	(381.7)	(43.7)
(Loss) earnings from operations	(0.4)	2.6	(3.0)	91.1	96.1	(5.0)
Interest and other	(7.4)	(4.4)	(3.0)	(23.4)	(14.1)	(9.3)
Net (loss) earnings before extraordinary gain	(7.8)	(1.8)	(6.0)	67.7	82.0	(14.3)
Extraordinary gain	0.0	0.0	0.0	0.0	61.3	(61.3)
Net (loss) earnings & comprehensive income	(7.8)	(1.8)	(6.0)	67.7	143.3	(75.6)

Our consolidated net earnings and comprehensive income in the three months ended December 31, 2007 were \$6.0 million (\$14.3 million year-to-date) lower than net earnings before extraordinary gain in the previous year. In the first quarter of 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 and nine months ended December 31, 2007 as shown in the table below.



During the nine months ended December 31, 2007, the greatest portion of our revenues, 60%, was earned on our three major routes connecting Vancouver Island to Vancouver and the Lower Mainland. The revenue from the northern routes contributed 8% and other routes contributed 31%. Remaining general revenue, 1%, consists mainly of marketing rights and interest earned.

Total Revenue

Revenue (\$ millions)	Three months ended December 31			Nine months ended December 31		
	2007	2006	Increase	2007	2006	Increase
Direct Route Revenue						
Vehicle traffic (volume)	1,899,519	1,875,587	23,932	6,852,281	6,814,852	37,429
Vehicle tariff	51.3	47.6	3.7	195.7	183.6	12.1
Passenger traffic (volume)	4,593,799	4,564,668	29,131	17,654,785	17,629,967	24,818
Passenger tariff	28.4	27.7	0.7	117.1	112.3	4.8
Social program fees	3.9	3.8	0.1	13.5	12.3	1.2
Catering & on-board	16.9	15.8	1.1	63.5	58.0	5.5
Other revenue	5.0	4.6	0.4	19.5	17.2	2.3
Total Direct Route Revenue	105.5	99.5	6.0	409.3	383.4	25.9
Indirect Route Revenue						
Ferry service fees	23.0	21.9	1.1	81.5	72.0	9.5
Federal-Provincial subsidy	6.5	6.3	0.2	19.4	19.0	0.4
Total Route Revenue	135.0	127.7	7.3	510.2	474.4	35.8
Other general revenue	1.5	0.8	0.7	6.3	3.4	2.9
Total Revenue	136.5	128.5	8.0	516.5	477.8	38.7

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 or shift traffic away from our busiest sailings. In calculating the price cap, vehicle and passenger tariffs are combined. The utilization of promotional fare reductions and the effects of being over or under the price cap may cause the average vehicle and passenger tariff rate to be under or over the statutory increase in any one period.

Changes for the three and nine months ended December 31, 2007 and 2006 for major, northern and other routes are discussed separately below.

Major Routes

Direct Route Revenue (\$000s)	Three months ended December 31			Nine months ended December 31		
	2007	2006	Increase (Decrease)	2007	2006	Increase (Decrease)
Vehicle traffic (volume)	848,844	832,992	15,852	3,153,246	3,084,809	68,437
Vehicle tariff	39,389	36,418	2,971	148,213	139,722	8,491
Passenger traffic (volume)	2,336,051	2,327,342	8,709	9,253,774	9,168,360	85,414
Passenger tariff	21,466	21,182	284	86,227	84,192	2,035
Social program fees	1,987	1,920	67	7,018	6,541	477
Catering & on-board	14,257	13,414	843	52,118	48,079	4,039
Reservation fees	3,041	2,802	239	11,698	10,582	1,116
Parking	739	705	34	2,478	2,435	43
Assured loading	577	482	95	2,124	1,658	466
Other revenue	207	272	(65)	736	779	(43)
Total Direct Route Revenue	81,663	77,195	4,468	310,612	293,988	16,624
Gross margin – catering & on-board	8,712	8,002	710	32,410	29,086	3,324

The major routes revenue is from customers and related social program fees, and includes no service fees.

Both vehicle traffic and passenger traffic increased over the prior year. The increase in average tariff revenue per vehicle was \$2.68 or 6.1% (\$1.71 or 3.8% year-to-date) while the increase in average tariff revenue per passenger was \$0.09 or 1.0% (\$0.14 or 1.5% year-to-date). The increased traffic and higher average fares resulted in a total increase of \$3.3 million (\$10.5 million year-to-date) 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.

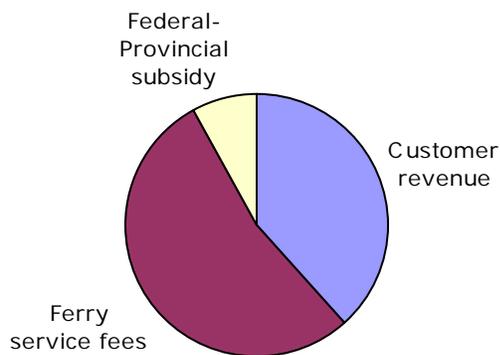
All of our vessels that provide service on our major routes have a gift shop and options for food service. Revenues from catering and on-board services increased \$0.8 million (\$4.0 million year-to-date) as a result of higher spending per passenger and the higher number of passengers carried. We have achieved higher sales while continuing to increase margins.

Fees for reservations 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 (\$000s)	Three months ended December 31			Nine months ended December 31		
	2007	2006	Increase	2007	2006	Increase
Vehicle traffic (volume)	4,713	4,161	552	29,628	22,004	7,624
Vehicle tariff	768	719	49	6,384	4,705	1,679
Passenger traffic (volume)	12,060	10,383	1,677	90,822	67,815	23,007
Passenger tariff	423	360	63	5,916	4,167	1,749
Social program fees	137	96	41	462	287	175
Catering & on-board	178	149	29	2,173	1,306	867
Reservation fees	11	11	0	63	31	32
Stateroom rental	129	83	46	797	275	522
Hostling	37	37	0	127	118	9
Other revenue	1	0	1	31	9	22
Total Direct Route Revenue	1,684	1,455	229	15,953	10,898	5,055
Indirect Route Revenue						
Ferry service fees	3,550	2,491	1,059	22,321	12,816	9,505
Federal-Provincial subsidy	1,097	1,074	23	3,292	3,222	70
Total Route Revenue	6,331	5,020	1,311	41,566	26,936	14,630
Gross margin – catering & on-board	86	53	33	1,208	695	513

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 during the nine months ended December 31, 2005.



Year-to-date revenue from our northern routes consists of 38% from customers and related social program fees, 54% from ferry service fees and 8% from payments under the Federal-Provincial subsidy agreement. The revenue from ferry service fees has increased 74% from fiscal 2007, reflecting resumption of full service with deployment of the new *Northern Adventure* on our northern routes.

Northern Routes, cont'd

The average tariff revenue per vehicle decreased \$9.84 or 5.7% (\$1.65 or 0.8% increase year-to-date). The average passenger tariff revenue increase was \$0.40 or 1.2% (\$3.69 or 6.0% year-to-date). The increased traffic and higher average tariff year-to-date resulted in a total tariff revenue increase of \$3.4 million year-to-date.

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 resumption of regular service and higher fares.

The increase in catering and on-board revenue resulted from the resumption of regular service and from higher food and gift shop sales per passenger. Stateroom revenue, fees for reservations, parking commissions and hostling have increased primarily as a result of the resumption of regular service.

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.

An emergency environmental plan was implemented in conjunction with external authorities. An extensive monitoring program determined that the spill from the sunken vessel was of short duration and there was minimal effect on the marine ecology of the region. The level of contaminants in edible organisms (i.e. shellfish) was very low and there was no risk for human consumption.

The feasibility and risk of recovering any fuel and lubricants that may remain in the vessel was investigated. The Canadian Coast Guard conclusions were 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, there is no plan to pursue fuel and lubricant recovery from the incident site.

We purchased oil spill response equipment for the Village of Hartley Bay and have provided oil spill response training to interested Hartley Bay residents. We engaged Hartley Bay residents in the ongoing monitoring of the incident site for leakage and of the adjacent waters for presence and distribution of oil sheen. We equipped them with portable global positioning systems to ensure accuracy of observation and reporting.

Our second stage environmental monitoring program, which started in the fall of 2007, focuses on testing of shellfish, a traditional food of First Nations. The results of samples collected and tested in September 2007 showed no evidence of contamination from fuel released from the wreck site. This environmental monitoring program will continue with shellfish samples tested before traditional harvesting seasons. We will continue to work with First Nations and other interested parties to ensure appropriate environmental monitoring and response.

Northern Routes, cont'd

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 was obtained, our divisional inquiry was reconvened, and an addendum to the report was released October 3, 2007. The divisional inquiry panel concluded that the new information did not change the original findings. The addendum and additional information have been provided to the Transportation Safety Board (TSB). The RCMP and TSB 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 from the level received prior to the loss of the *Queen of the North* by approximately \$11 million annually, beginning April 1, 2007. This level of service fees reflects the cost of the *Northern Adventure* including receipt of import duties remission and related GST totalling \$13.9 million.

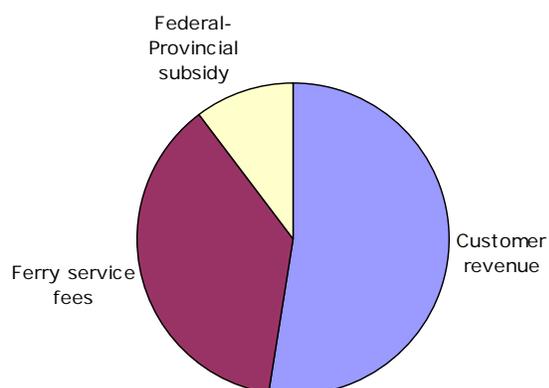
In August 2006, we signed a \$133 million contract with FSG to build the *Northern Expedition*, which is expected to replace the 41-year-old *Queen of Prince Rupert* currently operating on our northern routes. This 150-metre vessel, which is expected to be in service in the spring of 2009, will have 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.

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.

Other Routes

Direct Route Revenue (\$000s)	Three months ended December 31			Nine months ended December 31		
	2007	2006	Increase (Decrease)	2007	2006	Increase (Decrease)
Vehicle traffic (volume)	1,045,962	1,038,434	7,528	3,669,407	3,708,039	(38,632)
Vehicle tariff	11,146	10,442	704	41,150	39,180	1,970
Passenger traffic (volume)	2,245,688	2,226,943	18,745	8,310,189	8,393,792	(83,603)
Passenger tariff	6,518	6,112	406	24,919	23,893	1,026
Social program fees	1,817	1,771	46	5,972	5,427	545
Catering & on-board	2,480	2,267	213	9,203	8,622	581
Reservation fees	213	202	11	1,255	1,122	133
Parking	58	46	12	173	163	10
Other revenue	13	14	(1)	116	150	(34)
Total Direct Route Revenue	22,245	20,854	1,391	82,788	78,557	4,231
Indirect Route Revenue						
Ferry service fees	19,411	19,424	(13)	59,167	59,204	(37)
Federal-Provincial subsidy	5,367	5,254	113	16,100	15,760	340
Total Route Revenue	47,023	45,532	1,491	158,055	153,521	4,534
Gross margin – catering & on-board	1,566	1,426	140	5,878	5,362	516

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 and 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.



Year-to-date revenue from our other routes consists of 52% from customers, 38% from ferry service fees and 10% from payments under the Federal-Provincial subsidy agreement.

Other Routes, cont'd

We experienced an increase in vehicle and passenger traffic levels on our other routes in the quarter, but still remain below the prior year for the nine-month period. More than 24% of the year-to-date vehicle and passenger traffic decrease was as a result of the major refit of the *Mill Bay* which services our Mill Bay-Brentwood Bay route. Service on this route was suspended for almost two months in the first quarter to allow for this major refit which is scheduled to occur every four years.

The increase in average tariff revenue per vehicle was \$0.60 or 6.0% (\$0.65 or 6.1% year-to-date) while the average passenger tariff revenue increase was \$0.16 or 5.8% (\$0.15 or 5.3% year-to-date). The increased average fares, partially offset by the reduction in traffic levels year-to-date, resulted in a total tariff revenue increase of \$1.1 million (\$3.0 million year-to-date).

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

Increases in catering and on-board 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 have increased as a result of higher usage and higher rates. The decrease in other income year-to-date is mainly a result of additional revenue from charters in the first quarter of the prior year.

Expenses

Expenses for the three and nine months ended December 31, 2007 and 2006 are summarized in the table below.

(\$ millions)	Three months ended December 31			Nine months ended December 31		
	2007	2006	(Increase) \$	2007	2006	(Increase) \$
Operations	77.8	72.5	(5.3)	250.7	231.5	(19.2)
Maintenance	23.5	21.9	(1.6)	65.7	53.1	(12.6)
Administration	12.5	11.4	(1.1)	36.1	33.9	(2.2)
Cost of retail goods sold	6.6	6.4	(0.2)	24.0	22.9	(1.1)
Amortization	16.5	13.7	(2.8)	48.9	40.3	(8.6)
	136.9	125.9	(11.0)	425.4	381.7	(43.7)
Interest & other	7.4	4.4	(3.0)	23.4	14.1	(9.3)
Total expense	144.3	130.3	(14.0)	448.8	395.8	(53.0)

The \$5.3 million (\$19.2 million year-to-date) increase in operations expenses reflects:

- \$2.8 million (\$10.4 million year-to-date) increase in wages and benefits, including wage rate increases averaging approximately 4%;
- \$1.0 million (\$4.1 million year-to-date) in increased training and overtime costs;
- \$1.8 million year-to-date net increase in wages and benefits and contracted services reflecting the full service provided on our northern routes this year; and
- \$0.5 million (\$3.7 million year-to-date) increase in fuel expense reflecting the addition of the *Northern Adventure*, and an increase in set prices of 1.86% as ordered by the British Columbia Ferries Commissioner (the "Commissioner").

The \$1.6 million (\$12.6 million year-to-date) increase in maintenance costs reflects our continued commitment to safety and the age of our fleet. We have completed 15 vessel refits year-to-date with a further six in progress. We have also spent an additional \$2.4 million year-to-date on terminal maintenance compared to the prior year.

Administration expenses increased \$1.1 million (\$2.2 million year-to-date) mainly as a result of an increase in wages and benefits and partially for information technology support for system growth and development.

Amortization increased a total of \$2.8 million (\$8.6 million year-to-date) as a result of additional assets coming into service including \$1.5 million (\$4.5 million year-to-date) reflecting the *Northern Adventure* entering service in March 2007.

Interest expenses increased \$2.9 million (\$9.1 million year-to-date) primarily due to \$3.2 million (\$9.5 million year-to-date) additional interest relating to our third \$250 million bond series issued in March 2007 and \$0.8 million (\$1.7 million year-to-date) reduction in structured financing facility funding. These increases were partially offset by \$1.2 million (\$2.3 million year-to-date) of additional interest capitalized reflecting our investment in revitalizing our fleet and terminal facilities.

Fuel Deferral and Related Surcharge

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

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.

Under an agreement reached in March 2007, the Province made a one-time \$7.0 million ferry service fee payment for fiscal 2007, which was applied against the deferred fuel cost accounts in accordance with the agreement.

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 from time to time, 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 Commissioner has considered deferred fuel costs in establishing price cap increases for each of the four years of the second performance term, beginning April 1, 2008. These price cap increases provide for recovery of the forecast balance in the fuel deferral accounts at March 31, 2008 evenly over the four-year period.

The balances in our deferred fuel cost accounts totalled \$12.7 million at December 31, 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.

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 ended June 30, 2007, 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. The draws on this facility at December 31, 2007 were \$40 million.

On January 11, 2008, we closed a \$200 million senior secured bond issue, Series 08-1, due January 11, 2038. These private placement bonds will bear interest at 5.581% payable semi-annually. The net proceeds will be used to repay our credit facility, fund capital expenditures and the Series 08-1 debt service reserve fund and for general corporate purposes.

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, 2007 and 2006 are summarized in the table below.

(\$ millions)	Three months ended December 31		Nine months ended December 31	
	2007	2006	2007	2006
Net (loss) earnings before extraordinary gain	(7.8)	(1.8)	67.7	82.0
Extraordinary gain	-	-	-	61.3
Items not involving cash:				
Amortization	16.5	13.7	48.9	40.4
Other non-cash charges	0.5	(0.4)	0.8	0.1
Regulatory costs deferred	4.4	(0.6)	9.6	(3.1)
Change in operating working capital	5.5	15.7	(8.1)	(25.4)
Cash provided by operating activities	19.1	26.6	118.9	155.3
Cash provided by financing activities	39.8	41.4	14.9	41.3
Cash used in investing activities	(167.2)	(102.5)	(286.2)	(176.9)
Total (decrease) increase in cash	(108.3)	(34.5)	(152.4)	19.7

Three Months Ended December 31, 2007

Cash provided by operating activities includes a decrease in non-cash working capital of \$5.5 million for the three months ended December 31, 2007. This decrease was primarily due to:

- \$7.4 million decrease in accounts receivable, including decreases of:
 - \$3.8 million in ferry service fees;
 - \$2.5 million in social program fees;
 - \$0.8 million in commercial travel card receivables;
- \$2.3 million decrease in prepaid expenses primarily due to \$1.3 million decrease in property taxes; \$0.5 million decrease in fuel; and \$0.2 million decrease in insurance;
- \$0.2 million increase in payables and accrued liabilities relating to refit and maintenance and other operating activities;
- \$1.2 million increase in accrued employee costs; and
- \$2.4 million increase in deferred revenue mainly due to increases of \$2.0 million in assured loading ticket and \$0.9 million in commuter ticket sales.

These working capital decreases were partially offset by:

- \$4.2 million decrease in interest payable due to the timing of bond interest payments;
- \$2.6 million decrease in current regulatory liabilities reflecting the decrease in current portion of mark to market adjustments on derivative contracts entered into to hedge foreign exchange risk on capital projects, partially offset by \$1.0 million reflecting the increase in tariff revenues collected in excess of price caps; and
- \$1.2 million net increase in inventories.

Cash provided by financing activities reflects the net short-term draws on our credit facility.

Cash used in investing activities mainly consists of \$167.2 million used to purchase capital assets. The significant capital transactions are described below in "Investing in Our Capital Assets".

Nine Months Ended December 31, 2007

Cash provided by operating activities includes an increase in non-cash working capital of \$8.1 million for the nine months ended December 31, 2007. This increase was primarily due to:

- \$7.3 million decrease in payables and accrued liabilities relating to refit and maintenance and other operating activities;
- \$4.3 million decrease in interest payable due to the timing of bond interest payments;
- \$3.6 million increase in current regulatory assets (\$3.5 million of deferred fuel costs and \$0.1 million of performance term two submission costs), representing the amounts that will be amortized and recovered in tariffs during the first nine months of fiscal 2009; and
- \$0.9 million net increase in inventories and prepaid expenses.

The working capital increase was partially offset by:

- \$3.4 million decrease in accounts receivable resulting mainly from decreases of:
 - \$4.8 million in ferry transportation fees due to the receipt of \$6.1 million of fees outstanding at March 31, 2007 partially offset by a timing difference between when fees are received and when revenue is recognized;
 - \$2.6 million in miscellaneous receivables;These decreases were partially offset by increases of:
 - \$1.2 million in social program fees recoverable reflecting higher program usage and two months of receivable (one month at March 31, 2007);
 - \$3.0 million in commercial travel card receivables as a result of change in payment terms from net 7 to net 30 days;
- \$2.4 million increase in accrued employee costs;
- \$1.1 million increase in regulatory liabilities reflecting tariff revenues collected in excess of price caps; and
- \$1.1 million increase in deferred revenue as a result of:
 - \$1.2 million increase in commuter tickets;
 - \$2.7 million increase in assured loading tickets;
 - \$1.9 million decrease in reservation liabilities, reflecting the seasonal nature of our traffic patterns; and
 - \$0.9 million reduction in deferred advertising representing nine months of advertising income.

Cash provided by financing activities reflects the net draws on our short-term credit facility.

Cash used in investing activities consists of an \$11.2 million investment in short term investments and \$275.0 million used to purchase capital assets. The significant capital transactions are described below in "Investing in Our Capital Assets".

INVESTING IN OUR CAPITAL ASSETS

Capital expenditures in the three months ended December 31, 2007 totalled \$172.0 million on an accrual basis (\$251.9 million in the nine months ended December 31, 2007). This level of expenditure reflects significant investments in our fleet, terminals and information systems to increase customer service and operating efficiency. Total capital expenditures for the three and nine months ending December 31, 2007 were:

(\$ millions)	December 31, 2007	
	3 Months	9 Months
New vessels, vessel upgrades and modifications	158.2	214.7
Terminal marine structures	4.5	16.9
Terminal and building upgrades and equipment	6.6	15.1
Computer hardware and software development	2.7	5.2
Total Capital Expenditures	<u>172.0</u>	<u>251.9</u>

New Vessels, Vessel Upgrades and Modifications

Capital expenditures for new vessels, vessel upgrades and vessel modifications for the three and nine months ending December 31, 2007 included the following:

(\$ millions)	December 31, 2007	
	3 Months	9 Months
New <i>Coastal Renaissance</i> , <i>Coastal Inspiration</i> and <i>Coastal Celebration</i>	146.2	178.9
Mid-life upgrade to the <i>Queen of Alberni</i>	0.2	12.9
New <i>Northern Expedition</i>	0.4	7.6
New <i>Island Sky</i>	0.5	7.2
Life extension of the <i>Queen of New Westminster</i>	5.6	6.2
Completion of the <i>Northern Adventure</i> with post-acquisition modifications	1.8	4.6
Upgrade and replacement of propulsion and safety equipment on the <i>Quinsam</i> , <i>Quinitsa</i> and <i>Queen of Capilano</i>	0.2	2.0
Fire suppression system, improvements to crew safety and upgrades to accommodations for the <i>Howe Sound Queen</i>	0.3	1.8
Sewage treatment upgrade program for 13 vessels	1.4	1.7
Two-year project to install Voyage data recorders and upgrade vessel connectivity	1.2	1.5
Passenger accommodation upgrades on the <i>Queen of Burnaby</i>	-	1.4
Other projects	0.4	2.8
Import duties remission and related GST on the purchase of the <i>Northern Adventure</i>	-	(13.9)
	<u>158.2</u>	<u>214.7</u>

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 various sources such as navigation equipment, propulsion control systems, radio communications, voice audio and bridge ambient sounds. They have been installed on twelve vessels to date. Our intention is for the entire fleet to have VDRs fitted by October 2008 and for all new construction vessels to be fitted during construction.

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 \$39 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*.

The *Queen of New Westminster*, which usually operates on our Duke Point–Tsawwassen route, is currently undergoing a project to extend the life of the 44-year-old vessel for a further thirteen years of reliable service. This \$55 million project will include significant upgrades for structural fire protection; a new marine evacuation system; major electrical upgrades; boiler, auxiliary generator and emergency generator renewal; and propulsion controls upgrade. The *Queen of New Westminster* is expected to return to service in the fall of 2008 and be redeployed on our Tsawwassen–Swartz Bay route.

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 crew and 370 vehicles. The contracts are design-build and fixed price, totalling \$325 million. The contracts provide us with substantial guarantees related to delivery dates, performance criteria, cost certainty and quality of construction. These contracts, together with import 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 import duties and related GST of approximately \$86 million, 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 and construction of the *Coastal Celebration* began in April 2007. These new vessels will replace aging vessels that currently provide service on our major routes. The *Coastal Renaissance* arrived in BC on December 13, 2007, following a 48-day, 9,990 nautical mile trans-Atlantic voyage from Germany. Crew training and familiarization in the operation of this brand new state-of-the-art vessel is currently underway. The *Coastal Renaissance* is expected to enter service on the Departure Bay-Horseshoe Bay route in March 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 *Coastal Celebration* will journey home with promotional stops in London, Los Angeles and Seattle to raise awareness for the Games and to promote British Columbia as a tourist destination. We collaborated 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 FSG to build a new vessel which is expected to replace the 41-year-old *Queen of Prince Rupert* currently operating on our northern routes. The import duties and taxes on this contract will total approximately \$43 million. We will be seeking a remission of the import duties and related GST of approximately \$35 million, 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. The vessel design was completed in December 2007 and the first superstructure modules are being assembled. 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.

Northern Adventure

Our application for import duties remission relating to the purchase of the *Northern Adventure* was approved and \$13.1 million was received from the federal government in September 2007. Related GST of \$0.8 million has not yet been received. The total of \$13.9 million has been applied as a reduction of the cost of the vessel. In accordance with the Coastal Ferry Services Contract, the receipt of the import duties remission has resulted in a reduction in provincial northern service fees.

Island Sky

On November 20, 2007, the hull of the *Island Sky*, our new intermediate class ferry, was launched and subsequently towed to Victoria Shipyards where the superstructure will be loaded onto the vessel prior to returning to Vancouver Shipyards in North Vancouver for completion. 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 48-year-old *Queen of Tsawwassen*. The new vessel will measure 100-metres in length and have a capacity of approximately 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. Although the contract provides for delivery of this vessel by April 7, 2008, we have been informed by the shipyard that their revised estimate of the delivery date is June 30, 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.

Capital expenditures on terminal marine structures for the periods ending December 31, 2007 included the following:

(\$ millions)	Terminal	December 31, 2007	
		3 Months	9 Months
Upgrade of berths to accommodate the Super C-class vessels	Departure Bay	0.4	4.8
Upgrade of berths to accommodate the Super C-class vessels	Horseshoe Bay	1.0	3.8
Replacement of wingwall structures	Village Bay	1.1	1.4
Refurbish two floating leads and replace two others	Otter Bay	0.2	1.0
Completion of a dolphin replacement	Campbell River	-	0.6
Electrical upgrades	Departure Bay	0.1	1.3
Modifications to accommodate the <i>Northern Adventure</i>	Northern terminals	-	0.6
Other projects	Various	1.7	3.4
		<u>4.5</u>	<u>16.9</u>

To replace aging berths and to accommodate the Super C-class vessels, modifications of marine structures at three berths at Departure Bay terminal are complete. Modifications at Horseshoe Bay terminal are substantially complete with an in-service date prior to March 31, 2008. These berth refurbishments and upgrades include new trestles, dolphins¹ and catwalks.

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

Terminal and Building Upgrades and Equipment

Besides upgrades to terminal marine structures, many other terminal upgrades are underway to provide better service to our customers and improve operational efficiencies. The most significant activity this fiscal year has been at Swartz Bay, Departure Bay and Alert Bay. Capital expenditures on terminal and building upgrades and equipment for the periods ending December 31, 2007 included the following:

(\$ millions)	December 31, 2007	
	3 Months	9 Months
Swartz Bay terminal	2.0	5.9
Departure Bay terminal	4.0	6.9
Alert Bay terminal	0.0	1.0
Other terminals	0.6	1.3
	<u>6.6</u>	<u>15.1</u>

At Swartz Bay terminal, the holding compound and pre-ticket area are being expanded, new ticket booths built, the radar maintenance building relocated and the exit re-aligned. In the nine months ended December 31, 2007, \$5.6 million of the \$5.9 million spent on the terminal related to this \$9.2 million project.

At Departure Bay terminal, the holding compound, pick-up and drop-off area, and the short term parking are being expanded. A new retail building, ticket building, waiting room and washrooms are being built. The foot passenger walkway will be improved and the intersection realigned. In the nine months ended December 31, 2007, we completed \$6.9 million of this \$36.2 million project.

At Alert Bay terminal the holding compound was expanded, a pick-up/drop-off lane and passenger sidewalk created, and the waiting shelter replaced. We completed this \$2.2 million project in August 2007.

Information Technology

Capital expenditures in information technology include computer hardware and software development to improve operational data capture and reporting, time collection and database security.

We implemented a new system to capture and report operational statistics in a more timely and accurate manner. This system utilizes an integrated data management solution to standardize traffic data collection and capture processes.

We expect to launch a new card-based electronic payment method in the spring of 2008. This Smart Media card is an electronic swipe card that can be loaded with dollars and redeemed for travel (and eventually, other products and services) instead of using cash, credit cards or prepaid paper tickets. The new card will also offer customers loss protection, which is not available with the current prepaid paper tickets.

Other ongoing projects include enhanced reporting initiatives, better external and internal communications, real-time credit card authorization, automated ticketing, 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.

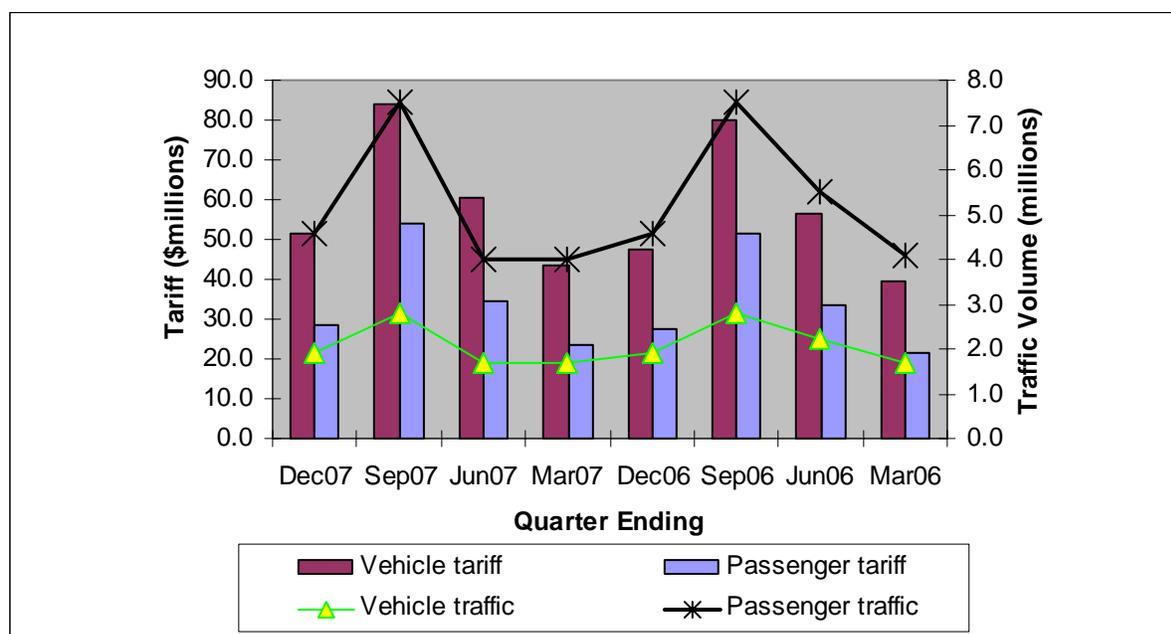
SUMMARY OF QUARTERLY RESULTS

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

(\$ millions)	Quarter Ended (unaudited)							
	Dec 07	Sep 07	Jun 07	Mar 07	Dec 06	Sep 06	Jun 06	Mar 06
Total revenue	136.5	220.2	159.8	119.0	128.4	202.7	146.4	109.7
(Loss) earnings from operations	(0.4)	69.4	22.1	(27.7)	2.5	73.0	20.3	(18.7)
Net (loss) earnings before extraordinary gain	(7.8)	61.0	14.4	(33.2)	(1.8)	68.9	14.9	(24.8)
Extraordinary gain	0.0	0.0	0.0	0.0	0.0	0.0	61.3	0.0
Net (loss) earnings and comprehensive income	(7.8)	61.0	14.4	(33.2)	(1.8)	68.9	76.2	(24.8)
Maintenance expense	23.5	20.7	21.4	31.8	21.9	13.4	17.9	28.1
Maintenance as % of total expense	17%	14%	16%	22%	17%	10%	14%	22%

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 and Environmental Protection

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. During the nine months ended December 31, 2007, we conducted 10,381 person training days which exceeds the total days of training conducted over the 12 months of fiscal 2007.

In October 2007, we officially launched SailSafe – a joint initiative with the BC Ferry & Marine Workers' Union that builds on our current safety practices and reflects our common commitment to safety as an essential part of our business and our daily work. This initiative will involve employees in identifying areas and methods for enhancing current safety practices and ensuring that safety is our first priority each and every day.

We are proactive in ensuring environmental regulations are met or exceeded and in developing strategies to help us become an industry leader in environmental management. We have programs in place to protect the environment and reduce greenhouse gas emissions and are introducing new initiatives to further mitigate our environmental impact. Besides recycling beverage containers, cardboard and newsprint, we are also:

- using biodegradable hydraulic oils;
- using low sulphur fuel in all vessels;
- replacing chemical products with more environmentally friendly solutions;
- recycling used cooking oil, spent fluorescent tubes and batteries;
- reviewing environmental performance of selected contractors; and
- replacing gasoline powered baggage vans with propane powered tugger units.

We have a fuel reduction strategy that is designed to reduce fuel consumption and emissions on our vessels. To date, we have implemented 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 and designing and building our new vessels to meet or exceed current environmental standards.

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. In December 2007 we took possession of the first Super-C class vessel, the *Coastal Renaissance*. We also 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, including the *Coastal Renaissance*. 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 earnings in the near term.

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 nine months ending December 31, 2007, we experienced increased traffic levels on our major and northern routes and an overall decrease in traffic levels on our other routes.

During the last two fiscal years, traffic levels were negatively affected by the loss of capacity on our northern routes, an unprecedented number of severe wind and snow storms in November and December 2006, and the implementation of three fuel surcharges. 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 in fiscal 2006, 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.

There has been rapid growth in the freight transport business, including container traffic, between Vancouver Island and the Lower Mainland. This growth is a result of improvements in transportation infrastructure in the Lower Mainland (largely driven by the province's Pacific Gateway initiative), population growth in mid and northern Vancouver Island and an increase in large "big box" retailers locating on Vancouver Island. Given the planned transportation improvements south of the Fraser River in the Lower Mainland, our strategy is to shift a larger portion of commercial traffic to our Tsawwassen–Duke Point route by utilizing promotional fare reductions. We also plan to increase the commercial capacity on this route with the deployment of the second Super C-class vessel, the *Coastal Inspiration*, in the summer of 2008.

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 September 2007, we assumed the management and development of the Town of Sidney's international ferry terminal under a 40-year lease. 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.

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. 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. There may also be an impact on required crew levels, training and certification which could increase our operating costs. 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 and certain other 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 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. The core service fees and service levels for the second term have been set and the Commissioner released a final performance term two price cap order. Under this order, the price cap increase (starting from a level which includes fuel surcharges in place at March 31, 2008) will be 7.3% on the major routes and 4.0% on all other routes effective April 1, 2008. On each subsequent April 1 of the four-year term, the price cap will increase by 2.7% plus 0.49 times the latest reported annual increase in the Consumer Price Index (British Columbia) on the major routes and 5.7% plus 0.73 times the Consumer Price Index (British Columbia) on all other routes.

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.

We are witnessing increased competition in the commercial sector, where three companies, including ourselves, are now vying for differing segments of the freight transport business between Vancouver Island and the Lower Mainland. To maintain and potentially increase our market share, we plan on improving operational efficiency and customer service on our three major routes. We will accomplish this by increasing capacity for both commercial and passenger vehicle traffic with the assignment of one Super C-class vessel to each major route and improving traffic efficiency at the Departure Bay and Horseshoe Bay terminals. We are also investigating other new service offerings.

In an effort to reduce costs on our regulated routes, as mandated by the *Coastal Ferry Act* we are also exploring opportunities with additional or alternative service providers. 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 March 2008. 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 provides details of the carrying value and fair value of the derivative instruments at December 31, 2007 and March 31, 2007.

	December 31, 2007				March 31, 2007	
	Number of swaps	Term to maturity (years)	Carrying Value Asset (Liability) (\$ millions)	Fair Value (Liability)	Carrying Value Asset (Liability) (\$ millions)	Fair Value
Commodity Fixed Price Swaps	3	Up to .5	1.2	1.2	0.7	0.7
Foreign Exchange Forward Transactions (Super C-class vessels)	18	Up to .5	(26.2)	(26.2)	0.0	(18.7)
Foreign Exchange Forward Transactions (Northern Expedition)	7	Up to 1.25	(1.6)	(1.6)	(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 December 31, 2007 we have recorded a receivable of \$1.2 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 Canadian Institute of Chartered Accountants (CICA) 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 nine months ended December 31, 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 December 31, 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 nine months ended December 31, 2007.

Changes in Accounting Policies

Effective April 1, 2007, we adopted the 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 nine months ended December 31, 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 nine months ended December 31, 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, represents 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 which will all be effective for us beginning April 1, 2008:

Section 1535, *Capital Disclosures* establishes standards for disclosing information about our capital and how it is managed. The standard requires disclosure 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 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* 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. We do not expect application of this section to have a significant impact on our consolidated financial statements.

Section 3863, *Financial Instruments – Presentation* 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.

Effective for us beginning April 1, 2009, and applied prospectively, are amendments to Sections 1100 *Generally Accepted Accounting Principles*, 3465 *Income Taxes* and Accounting Guideline AcG-19 *Disclosures by Entities Subject to Rate Regulation*. With release of these amendments, a temporary exemption that permitted assets and liabilities arising from rate regulation to be recognized and measured on a basis other than in accordance with the primary sources of generally accepted accounting principles will be removed. In addition, accounting recommendations have been amended to require recognition of future income tax liabilities and assets as well as offsetting regulatory assets and liabilities at entities subject to rate regulation. We do not expect application of these amendments to have any impact on our consolidated financial statements. We will continue to monitor any additional implications on our financial reporting related to accounting for rate regulated operations.

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 December 31, 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 December 31, 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 third 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.