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

For the three and nine months ended December 31, 2008
Dated January 30, 2009

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The following is our discussion and analysis of the financial condition and results of operations for British Columbia Ferry Services Inc. as of December 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, 2008 and 2007, and our annual audited consolidated financial statements and related notes together with our fiscal 2008 Management's Discussion and Analysis. These documents are available on our Investor webpage at http://www.bcferries.com/about/investors/index.html and 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 37 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 British Columbia.

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 of the year. 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, 2008 (the third quarter of fiscal 2009), we provided 46,000 sailings, carrying more than 4.3 million passengers and 1.7 million vehicles.

We have experienced a decrease in traffic in all three quarters of fiscal 2009 compared to the same period in the prior year. Vehicle traffic was 7.6% lower in the third quarter (5.1% year-to-date) and passenger traffic was 5.9% lower (4.5% year-to-date). These reductions are due at least in part to the declines in the British Columbia and local economies experienced this year. We believe that the decreasing level of economic activity, rising unemployment, reduced consumer confidence and higher vehicle fuel prices earlier this fiscal year, have all negatively impacted our commercial and discretionary travel markets. In addition, in the month of December, traditionally a busy month, we experienced a decrease of 10% in traffic mainly due to severe weather. For three weeks, our service areas were faced with high winds, record snowfalls, black ice, freezing rain and impassable roads. We continue to review and update our financial and operating plans to respond to current economic uncertainties and reduced traffic levels. (See "Outlook–Traffic" and "Outlook–Corporate Restructuring" below for more detail.)

Significant events during or subsequent to our third quarter of fiscal 2009:

- On November 18, 2008, a decommissioning ceremony was held for the *Queen of Saanich* in recognition of 45 years of service. We also intend to retire the *Queen of Vancouver* prior to the end of fiscal 2009 and have offered these vessels for sale.

- On November 21, 2008, the third and final new Super C-class vessel, the *Coastal Celebration*, commenced service on the Swartz Bay–Tsawwassen route following crew training and familiarization in the operation of this state-of-the-art ferry. This 160-metre vessel accommodates up to 370 vehicles and 1,650 passengers. The total project budget for the three new Super C-class vessels was $542 million. The project was completed on schedule and under budget. (See "Investing in our Capital Assets" below for more detail).

- On November 21, 2008, the British Columbia Ferries Commissioner (the Commissioner) authorized the elimination of all remaining fuel surcharges in order to reflect the continuing drop in fuel prices. Fuel surcharges (excluding the northern routes) went into effect on August 1, 2008, and were subsequently reduced by 50% on November 4, 2008. (See "Outlook-Traffic" below for more detail). All of the Commissioner's Orders can be viewed at www.bcferrycommission.com.

- On December 5, 2008, we took delivery of the *Island Sky*, our new intermediate class ferry. This 102-metre vessel accommodates up to 125 vehicles and 600 passengers and is expected to be in service in the spring of 2009. A $47 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).

- On December 19, 2008, a fare reduction and service restoration agreement was made with the Province to provide $19.6 million in funding to allow a 33% reduction on fares for all routes during the months of December 2008 and January 2009 and for our Prince Rupert-Skidegate route during February 2009. It also provides $1.2 million additional funding for reimbursement of costs to reinstate previously eliminated off-peak sailings. (See "Outlook-Traffic" below for more detail).

- On December 19, 2008, we completed a $140 million, five-year senior secured bond issue. These private placement bonds bear interest at 6.214%, payable semi-annually. The net proceeds were used to repay our credit facility, fund capital expenditures and the debt service reserve related to the bonds and for general corporate purposes. Our credit ratings at December 31, 2008 were A low (DBRS) and A- (Standard & Poor's) and both rating agencies have assessed our rating outlook as positive. (See "Liquidity and Capital Resources" below for more detail.)

- On January 20, 2009, we announced a significant restructuring of our management and administrative staff, with 35 staff including several senior managers and director-level employees being released to date. Further changes and possible layoffs are anticipated in shore-based positions, including unionized staff positions. These changes have been made in order to align our expenses with our revenues. (See "Outlook-Corporate Restructuring" below for more detail).

- On January 20, 2009, due to the continuing decline in the price of fuel, we announced fuel rebates of up to 5% on many of our routes.. At this time we cannot offer fuel rebates on the major and northern routes due to the balances in the deferred fuel cost accounts for these routes. (See "Outlook-Traffic" below for more detail).

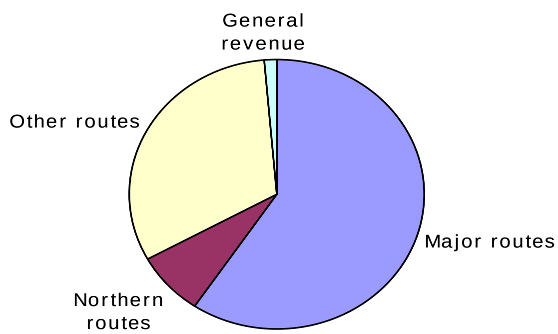
- On January 26, 2009, to coincide with conditional acceptance of the *Northern Expedition*, we received $108 million in proceeds under a loan agreement with the KfW bank group (KfW). This is a 12-year amortizing loan, at a fixed interest rate of 2.95%, payable semi-annually. The proceeds were applied toward the purchase of the new vessel. (See "Liquidity and Capital Resources" below for more detail.)

- On January 30, 2009, the new *Northern Expedition* departed Flensburger Schiffbau-Gesellschaft (FSG) in Germany for the 10,000 nautical mile journey to British Columbia. The *Northern Expedition* will replace the 42-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, has 55 staterooms and accommodates up to 130 vehicles and 600 passengers. The total project budget for this vessel is $200 million. The project is currently on schedule and on budget. (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 and nine months ended December 31, 2008 and 2007.

	Three Months Ended December 31			Nine Months Ended December 31		
($ millions)	2008	2007	Variance	2008	2007	Variance
Total revenue	149.4	136.5	12.9	553.4	516.5	36.9
Operating expenses	(151.1)	(136.9)	(14.2)	(470.5)	(425.4)	(45.1)
(Loss) earnings from operations	(1.7)	(0.4)	(1.3)	82.9	91.1	(8.2)
Interest and other	(12.9)	(7.4)	(5.5)	(35.4)	(23.4)	(12.0)
Net (loss) earnings & comprehensive income	(14.6)	(7.8)	(6.8)	47.5	67.7	(20.2)

Revenue
Our total revenues in the nine months ended December 31, 2008 increased over the previous year as shown in the table below.



During the nine months ended December 31, 2008, 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%. General revenue, 1%, consists mainly of interest earned, retail commissions and license fees.

Our largest revenue source is vehicle and passenger tariffs. The price cap increase authorized by the Commissioner was 7.3% on the major routes and 4.0% on all other routes effective April 1, 2008, starting from a level which included fuel surcharges in place at March 31, 2008. On April 1, we implemented tariff increases in line with these price cap adjustments. 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. The price caps will increase by 3.74% on the major routes and 7.25% on all other routes on April 1, 2009.

From time to time, we utilize promotional fare incentives designed to stimulate growth in traffic or direct traffic towards our less busy sailings. In calculating the price cap, vehicle and passenger tariffs are combined. The utilization of promotional fare incentives 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.

Year to year changes for the three and nine months ended December 31 for total revenue are summarized in the table below.

	Three months ended December 31			Nine months ended December 31		
Revenue ($ millions)	2008	2007	Increase (Decrease)	2008	2007	Increase (Decrease)
Direct Route Revenue						
Vehicle traffic (volume)	1,754,577	1,899,519	(144,942)	6,501,730	6,852,281	(350,551)
Vehicle tariff	58.0	51.3	6.7	219.2	195.7	23.5
Passenger traffic (volume)	4,320,847	4,593,799	(272,952)	16,857,322	17,654,785	(797,463)
Passenger tariff	33.6	28.4	5.2	132.4	117.1	15.3
Social program fees	4.8	3.9	0.9	16.2	13.5	2.7
Catering & on-board	16.3	16.7	(0.4)	62.1	63.1	(1.0)
Other revenue	4.5	5.2	(0.7)	17.8	20.0	(2.2)
Total Direct Route Revenue	117.2	105.5	11.7	447.7	409.4	38.3
Indirect Route Revenue						
Ferry transportation fees	24.3	23.0	1.3	82.4	81.4	1.0
Federal-Provincial subsidy	6.6	6.5	0.1	19.7	19.4	0.3
Total Route Revenue	148.1	135.0	13.1	549.8	510.2	39.6
Other general revenue	1.3	1.5	(0.2)	3.6	6.3	(2.7)
Total Revenue	149.4	136.5	12.9	553.4	516.5	36.9

Both vehicle traffic and passenger traffic have declined from the prior year. Dramatically higher vehicle fuel prices earlier this year and the continued worsening of the British Columbia and local economies have contributed to this decline. In addition, in the month of December, traditionally a busy month, we experienced a decrease of 10% in traffic mainly due to severe weather.

On December 19, 2008, a fare reduction and service restoration agreement was made with the Province to provide $19.6 million in funding to allow a 33% reduction on fares for all routes during the months of December 2008 and January 2009 and for our Prince Rupert-Skidegate route during February 2009. Fares were reduced and, in December, $10.9 million was recorded in tariff revenue. This fare reduction was expected to stimulate traffic; however, traffic in December was negatively impacted by three weeks of severe weather conditions.

As a result of the dramatic increase in fuel prices over the first part of this year, fuel surcharges were implemented on August 1, 2008. Subsequently, approval was received from the Commissioner to reduce these fuel surcharges by 50% on November 4, 2008, in order to reflect the more recent drop in fuel prices. These fuel surcharges were further reduced to zero on the major routes on December 19, 2008 and the other routes on December 5, 2008. The fuel cost deferral accounts (excluding those of the major and northern routes) were reduced by $1.3 million, nine months of the agreed annual $1.7 million, to be received from the Province. As it did in fiscal 2008, the Province has agreed to apply this payment to the fuel deferral accounts which will benefit our customers through reduced fuel surcharges or earlier fuel rebates. This benefit is equal to the amount by which annual ferry transportation fees payable by the Province were reduced as a result of the lower cost of the *Northern Adventure* due to remission and refund of import duties paid. Fuel rebates will be implemented on many of our routes (excluding the major and northern routes) in February 2009. In the nine months ending December 31, 2008, we collected $17.0 million in fuel surcharges from customers and invoiced the Province $2.6 million for fuel costs on the northern routes. These amounts were applied to the outstanding deferred fuel cost account balances. The balance in the deferred fuel cost accounts at December 31, 2008 was $20.8 million ($11.9 million at March 31, 2008).

Year to year changes for the three and nine months ended December 31 for the major, northern and other routes are discussed separately below.

Major Routes

Direct Route Revenue ($ thousands)	Three months ended December 31			Nine months ended December 31		
	2008	2007	Increase (Decrease)	2008	2007	Increase (Decrease)
Vehicle traffic (volume)	790,895	848,844	(57,949)	2,984,949	3,153,246	(168,297)
Vehicle tariff	44,706	39,389	5,317	165,033	148,212	16,821
Passenger traffic (volume)	2,208,678	2,336,051	(127,373)	8,762,673	9,253,774	(491,101)
Passenger tariff	25,678	21,466	4,212	96,898	86,227	10,671
Social program fees	2,407	1,988	419	8,190	7,018	1,172
Catering & on-board	13,657	13,900	(243)	50,190	50,999	(809)
Reservation fees	2,495	3,041	(546)	10,318	11,698	(1,380)
Parking	744	739	5	2,629	2,478	151
Assured loading	436	577	(141)	1,616	2,124	(508)
Other revenue	535	564	(29)	1,609	1,856	(247)
Total Direct Route Revenue	90,658	81,664	8,994	336,483	310,612	25,871
Gross margin – catering & on-board	8,183	8,355	(172)	30,676	31,291	(615)

Pursuant to an agreement with the Province, funding is being provided to allow a 33% reduction of fares on the major routes during the months of December 2008 and January 2009. For the month of December 2008, $8.3 million was recorded as tariff revenue ($5.2 million for vehicles and $3.1 million for passengers). The remainder of revenue on the major routes is from customers and related social program fees. No ferry transportation fees are received for service provided on these routes.

Major Routes, continued

Both vehicle traffic and passenger traffic decreased over the prior year. The reduction in total tariff revenue as a result of these volume decreases was more than offset by the increase in average tariff revenue. The increase in average tariff revenue per vehicle in the third quarter was $10.13 or 21.8% ($8.29 or 17.6% year-to-date) while the increase in average tariff revenue per passenger in the third quarter was $2.44 or 26.6% ($1.74 or 18.7% year-to-date). A significant portion of these increases represents fuel surcharges previously paid by customers and credited to fuel cost deferral accounts, which are now included in tariff revenue by order of the Commissioner. During the third quarter of fiscal 2008, these surcharges paid by customers amounted to $3.2 million ($19.4 million for the nine months ended December 31, 2007). The April 1, 2008 price cap increase on the major routes was 7.3% starting from a level which included fuel surcharges in place at March 31, 2008. The higher average fares, partially offset by the decrease in traffic and significant use of promotional discount fares during the first quarter, resulted in a total increase of $9.5 million ($27.5 million year-to-date) in tariff revenue.

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

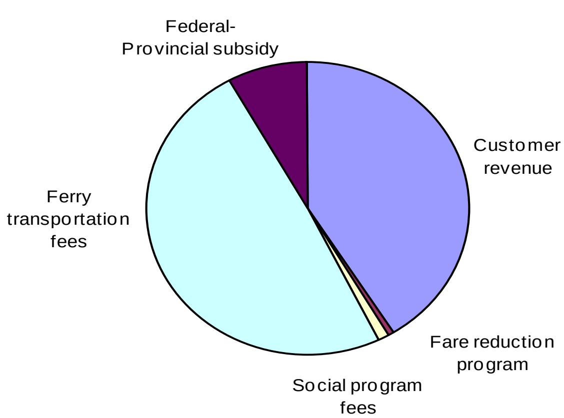
All of our vessels that provide service on our major routes have a gift shop and options for food service. Although the spending per passenger on catering and on-board services increased 3.8% (increase of 3.6% in gross margin) for the nine months ended December 31, 2008, this increase was more than offset by a decrease in overall sales as a result of the lower number of passengers carried. The lower fees for reservations and assured loading revenue also reflect the lower traffic levels.

Parking revenue increased significantly in the second quarter of fiscal 2009 while other revenue is lower as a result of reduced video and vending revenues partially offset by retail commissions arising from the opening of the Departure Bay Quay.

Northern Routes

Direct Route Revenue ($ thousands)	Three months ended December 31 2008	2007	Increase (Decrease)	Nine months ended December 31 2008	2007	Increase (Decrease)
Vehicle traffic (volume)	4,218	4,713	(495)	28,341	29,628	(1,287)
Vehicle tariff	845	767	78	7,546	6,385	1,161
Passenger traffic (volume)	9,934	12,060	(2,126)	84,627	90,822	(6,195)
Passenger tariff	484	424	60	6,834	5,916	918
Social program fees	147	137	10	548	462	86
Catering & on-board	161	177	(16)	2,094	2,170	(76)
Reservation fees	11	11	-	58	63	(5)
Stateroom rental	83	129	(46)	711	797	(86)
Hostling[1]	36	37	(1)	124	127	(3)
Other revenue	5	3	2	32	35	(3)
Total Direct Route Revenue	1,772	1,685	87	17,947	15,955	1,992
Indirect Route Revenue						
Ferry transportation fees	4,438	3,550	888	20,602	22,321	(1,719)
Federal-Provincial subsidy	1,115	1,097	18	3,347	3,292	55
Total Route Revenue	7,325	6,332	993	41,896	41,568	328
Gross margin – catering & on-board	114	85	29	1,401	1,205	196

Our northern routes consist of three regulated routes operating on the British Columbia coast north of Port Hardy on Vancouver Island.



In the nine months ended December 31, 2008, revenue from our northern routes consisted of 41% from customers and 59% from the Province (1% fare reduction agreement, 1% social program fees, 49% transportation fees, and 8% from payments under the Federal-Provincial subsidy agreement).

[1] Loading and unloading of commercial trailers that are dropped off for transportation on a ferry route.

Northern Routes, continued

Pursuant to an agreement with the Province, funding is being provided to allow a 33% reduction of fares on the northern routes during the months of December 2008 and January 2009 and for our Prince Rupert-Skidegate route during February 2009. For the month of December 2008, $0.2 million has been recorded as tariff revenue ($0.1 million for vehicles and $0.1 million for passengers).

The average tariff revenue per vehicle in the third quarter increased $37.59 or 23.1% ($50.75 or 23.5% year-to-date). The average passenger tariff revenue increase in the third quarter was $13.56 or 38.6% ($15.61 or 24.0% year-to-date). A significant portion of these increases represents fuel surcharges previously paid by customers and credited to fuel cost deferral accounts, which are now included in tariff revenue by order of the Commissioner. During the third quarter of fiscal 2008, these surcharges paid by customers amounted to $0.1 million ($2.0 million for the nine months ended December 31, 2007). The April 1, 2008 price cap increase on the northern routes was 4.0% starting from a level which included fuel surcharges in place at March 31, 2008. The higher average tariff, partially offset by lower traffic, resulted in a total tariff revenue increase of $0.1 million in the third quarter ($2.1 million year-to-date).

We receive ferry transportation fees for these routes under the Coastal Ferry Services Contract. The increase in fees in the third quarter compared to the prior year reflects the December 2007 year-to-date reduction for receipt of import duties remission and the related GST for the *Northern Adventure*. The decrease in fees year-to-date compared to the prior year reflects the effects of a full year reduction in fees resulting from the lower cost of the *Northern Adventure* and a change in the timing of the payment of ferry transportation fees in the second performance term which better reflects the seasonality of our business.

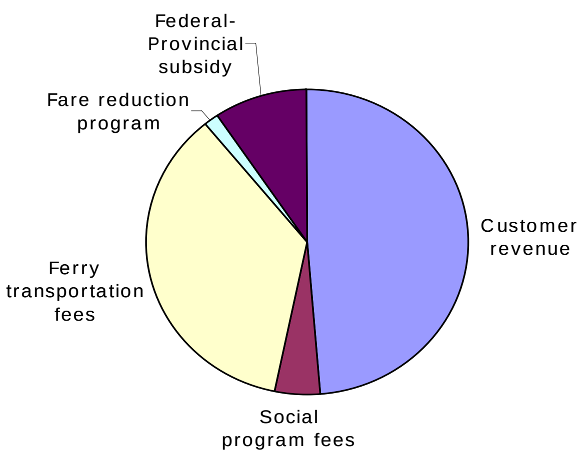
Reimbursements from the Province for social program fees increased mainly as a result of increased program usage and higher fares.

Other Routes

Direct Route Revenue ($ thousands)	Three months ended December 31			Nine months ended December 31		
	2008	2007	Increase (Decrease)	2008	2007	Increase (Decrease)
Vehicle traffic (volume)	959,464	1,045,962	(86,498)	3,488,440	3,669,407	(180,967)
Vehicle tariff	12,423	11,148	1,275	46,666	41,150	5,516
Passenger traffic (volume)	2,102,235	2,245,688	(143,453)	8,010,022	8,310,189	(300,167)
Passenger tariff	7,475	6,518	957	28,623	24,919	3,704
Social program fees	2,228	1,817	411	7,452	5,972	1,480
Catering & on-board	2,393	2,457	(64)	9,097	9,106	(9)
Reservation fees	175	211	(36)	1,102	1,254	(152)
Parking & other	92	95	(3)	345	386	(41)
Total Direct Route Revenue	24,786	22,246	2,540	93,285	82,787	10,498
Indirect Route Revenue						
Ferry transportation fees	19,870	19,411	459	61,757	59,167	2,590
Federal-Provincial subsidy	5,458	5,367	91	16,373	16,100	273
Total Route Revenue	50,114	47,024	3,090	171,415	158,054	13,361
Gross margin – catering & on-board	1,533	1,543	(10)	5,890	5,781	109

Our other routes consist of 19 regulated routes and eight small unregulated routes primarily serving the 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 transportation fees in the above table.



In the nine months ended December 31, 2008, revenue from our other routes consisted of 49% from customers and 51% from the Province (1% fare reduction agreement, 4% social program fees, 36% ferry transportation fees, and 10% from payments under the Federal-Provincial subsidy agreement).

We experienced a continued decrease in vehicle and passenger traffic levels on our other routes in the third quarter of fiscal 2009 partially due to the adverse impact of three weeks of severe weather conditions in December. The reduction in total tariff revenue as a result of lower traffic levels was more than offset by the increase in average vehicle and passenger tariff revenue.

Other Routes, continued

Pursuant to an agreement with the Province, funding is being provided to allow a 33% reduction of fares on the other routes during the months of December 2008 and January 2009. For the month of December 2008, $2.4 million has been recorded as tariff revenue ($1.5 million for vehicles and $0.9 million for passengers).

The increase in average tariff revenue per vehicle in the third quarter was $2.29 or 21.5% ($2.16 or 19.3% year-to-date) while the average passenger tariff revenue increase in the third quarter was $0.66 or 22.8% ($0.57 or 19.0% year-to-date). A significant portion of these increases represents fuel surcharges previously paid by customers and credited to fuel cost deferral accounts, which are now included in tariff revenue by order of the Commissioner. During the third quarter of fiscal 2008, these surcharges paid by customers amounted to $1.8 million ($10.5 million for the nine months ended December 31, 2007). The April 1, 2008 price cap increase on our other regulated routes was 4.0% starting from a level which included fuel surcharges in place at March 31, 2008. The increased average fares, partially offset by the reduction in traffic levels, resulted in a total tariff revenue increase of $2.2 million ($9.2 million year-to-date).

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

We receive ferry transportation fees for these routes under the Coastal Ferry Services Contract. The increase reflects a higher level of fees in fiscal 2009 compared to fiscal 2008 and a change in the timing of the payment of ferry transportation fees in the second performance term which better reflects the seasonality of our business.

Fees for reservations have decreased as a result of lower traffic. The decrease in other income is mainly a result of additional revenue from charters in the second quarter of the prior year.

Expenses
Expenses for the three and nine months ended December 31, 2008 and 2007 are summarized in the tables below.

Operating expenses	Three months ended December 31			Nine months ended December 31		
($ millions)	2008	2007	(Increase) Decrease	2008	2007	(Increase) Decrease
Operations	89.8	77.8	(12.0)	291.5	250.7	(40.8)
Maintenance	20.8	23.5	2.7	55.6	65.7	10.1
Administration	10.8	12.5	1.7	34.1	36.1	2.0
Cost of retail goods sold	6.3	6.6	0.3	23.2	24.0	0.8
Amortization	23.4	16.5	(6.9)	66.1	48.9	(17.2)
Total Operating Expenses	151.1	136.9	(14.2)	470.5	425.4	(45.1)

The $12.0 million ($40.8 million year-to-date) increase in operations expenses reflects:

- $9.7 million ($32.4 million year-to-date) increase in fuel expense reflecting the increase in the per litre cost of fuel, partially offset by $0.6 million due to a reduction in litres consumed in the nine months ended December 31, 2008 as a result of our fuel reduction strategy. For performance term two, the Commissioner increased the price of fuel to be included in the determination of price caps by 81.3% from the prior year in order to reflect higher fuel prices;

- $3.4 million ($8.6 million year-to-date) increase in wages and benefits, including:
  - Approximately $1.6 million ($4.0 million year-to-date) in wage rate increases averaging about 3% primarily in accordance with the existing Collective Agreement;
  - $2.2 million ($4.5 million year-to-date) increase in benefit costs; and
  - $0.1 million decrease ($0.8 million increase year-to-date) in training costs.

  These increases were partially offset by reductions resulting from the deferral of filling staff vacancies.

Increases in fuel and wage costs were partially offset by cost reduction initiatives which included the reduction of shore-based administrative support areas and other discretionary expenditures and $0.5 million in funding from the Province for reimbursement of costs to reinstate previously eliminated off-peak sailings.

Maintenance costs are $2.7 million ($10.1 million year-to-date) lower than the prior year reflecting the cyclical nature of our refit schedules. We plan to undertake 20 vessel refits in fiscal 2009, compared to 26 in the prior year.

Administration expenses decreased $1.7 million ($2.0 million year-to-date) mainly as a result of the deferral of filling staff vacancies and deferring or reducing travel, consulting, marketing, advertising and other discretionary expenditures.

Amortization increased a total of $6.9 million ($17.2 million year-to-date) mainly as a result of additional assets coming into service, including $4.6 million ($10.6 million year-to-date) reflecting the *Coastal Renaissance,* the *Coastal Inspiration,* and the *Coastal Celebration* entering service in March 2008, June 2008 and November 2008, respectively; and $1.2 million ($3.5 million year-to-date) in amortization of deferred fuel cost balances. The Commissioner has included $18.5 million of deferred performance term one fuel costs in determining the price caps for the four-year second performance term commencing April 1, 2008.

Expenses, continued

Interest & Other	Three months ended December 31			Nine months ended December 31		
($ millions)	2008	2007	(Increase) Decrease	2008	2007	(Increase) Decrease
(Gain) on foreign exchange	-	-	-	(0.2)	(0.2)	-
Interest expense	12.0	7.3	(4.7)	35.9	23.4	(12.5)
Loss (gain) on disposal of capital assets	0.9	0.1	(0.8)	(0.3)	0.2	0.5
Total Interest and Other	12.9	7.4	(5.5)	35.4	23.4	(12.0)

Interest expense increased $4.7 million ($12.5 million year-to-date) as detailed in the table below. This increase is mainly due to our $200 million and $140 million bond series issued in January 2008 and December 2008 respectively and the two KfW loans which partially finance the purchase of the *Coastal Inspiration* and *Coastal Celebration* (See "Liquidity and Capital Resources" below for more detail.) During the third quarter, agreements were completed that will provide us with a further $11.7 million of interest expense reimbursements through the Structured Financing Facility Program relating to the purchase of the new intermediate vessel, the *Island Sky,* and the life-extension of the *Queen of New Westminster*.

Interest Expense	Three months ended December 31			Nine months ended December 31		
($ millions)	2008	2007	(Increase) Decrease	2008	2007	(Increase) Decrease
Bond interest	13.9	10.8	(3.1)	41.0	32.3	(8.7)
KfW loans	2.3	-	(2.3)	6.5	-	(6.5)
Short-term loans	0.3	0.1	(0.2)	0.7	0.4	(0.3)
Interest on deferred accounts	(0.1)	(0.2)	(0.1)	-	(0.7)	(0.7)
Structured Financing Facility Program	(1.2)	(0.5)	0.7	(1.1)	(2.1)	(1.0)
Capitalized interest	(3.2)	(2.9)	0.3	(11.2)	(6.5)	4.7
Total Interest Expense	12.0	7.3	(4.7)	35.9	23.4	(12.5)

We reported a $1.2 million gain from the sale of the *Queen of Esquimalt* in the three months ended June 30, 2008. This has been partially offset in the third quarter with losses from replacement or disposal of terminal structures and equipment.

LIQUIDITY AND CAPITAL RESOURCES

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. With the completion of the $108 million KfW loan in January 2009, our major financing requirements are now complete. Our ongoing capital expenditures are expected to be significantly lower than in the previous few years. Over the next five years, we expect our cash requirements will be met through operational cash flows and by accessing our credit facility from time to time. At December 31, 2008 our unrestricted cash and cash equivalents totalled $132 million.

We target maintaining a strong investment-grade credit rating to allow capital market access at reasonable interest rates. Our credit ratings at December 31, 2008 were A low (DBRS) and A- (Standard & Poor's) and both rating agencies have assessed our rating outlook as positive.

In May 2008, we negotiated an extension of the $155 million credit facility by one year. The new maturity of this facility is May 12, 2013. At December 31, 2008, we had drawn $53 million on this credit facility.

In May 2008, to coincide with conditional acceptance of the *Coastal Celebration*, we received $90 million in proceeds under the loan agreement with KfW. This is a 12-year amortizing loan, at a fixed interest rate of 4.98%. The agreement defers the principal payments for the first three years to a second tranche on which interest only is payable at a floating rate. This principal is due June 2020.

In December 2008, we completed a $140 million, five-year senior secured bond issue. These private placement bonds bear interest at 6.214%, payable semi-annually. The net proceeds were used to repay our credit facility in January 2009 as the instruments matured, to fund capital expenditures and the debt service reserve related to the bonds and for general corporate purposes.

In January 2009, to coincide with conditional acceptance of the *Northern Expedition*, we received $108 million in proceeds under a further loan agreement with KfW. This is a 12-year amortizing loan, at a fixed interest rate of 2.95%, payable semi-annually. The proceeds were applied toward the purchase of the new vessel.

Sources & Uses of Cash

Our liquidity needs are met through a variety of sources, including cash generated from operations, issuance of bonds, 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, 2008 and 2007 are summarized in the table below.

	Three months ended December 31		Nine months ended December 31	
($ millions)	2008	2007	2008	2007
Net (loss) earnings	(14.6)	(7.8)	47.5	67.7
Items not involving cash:				
Amortization	23.4	16.5	66.1	48.9
Other non-cash charges	1.3	0.5	0.7	0.7
Regulatory costs deferred	(3.5)	5.3	(2.8)	10.2
Change in operating working capital	1.7	4.7	(23.7)	(8.5)
Cash provided by operating activities	8.3	19.2	87.8	119.0
Cash provided by financing activities	181.1	39.7	281.5	14.8
Cash used in investing activities	(63.3)	(167.2)	(353.3)	(279.0)
Total increase (decrease) in cash	126.1	(108.3)	16.0	(145.2)

Three Months Ended December 31, 2008

In the three months ended December 31, 2008, cash provided by operating activities reflected a decrease in non-cash working capital of $1.7 million. This reduction in working capital was primarily due to:

- $4.0 million reduction in accounts receivable resulting mainly from:
    - $5.1 million in commercial travel cards receivable due to lower usage resulting from reductions in commercial traffic and seasonality; partially offset by:
    - $1.2 million increase in receivables from the Province, including:
        - $1.4 million receivable for December 2008 under the fare reduction and service restoration agreement; and
        - $1.3 million applied to the fuel cost deferral accounts pursuant to an agreement with the Province.

      These increases were partially offset by a $1.3 million reduction mainly relating to the payment of fuel costs for the northern routes; and
- $0.6 million reduction in inventories.

The above items, which decreased working capital, were partially offset by:

- $1.1 million reduction in interest payable due to timing of interest payments;
- $0.7 million increase in prepaid expenses primarily due to $2.3 million in prepaid fuel, partially offset by a $1.3 million reduction in prepaid property tax and reductions in other prepaid expenses;
- $0.5 million reduction in payables and accrued liabilities relating to refit and maintenance and other operating activities;
- $0.4 million reduction in accrued employee costs; and
- $0.2 million reduction in deferred revenue.

Cash provided by financing activities reflects the $140 million Series 08-2 bond issuance and $42 million draws on our $155 million credit facility during the three month period. These draws were repaid in January 2009 as the instruments matured.

Cash used in investing activities consists mainly of $61.5 million used to purchase capital assets. The significant capital transactions are described below in "Investing in Our Capital Assets".

Nine Months Ended December 31, 2008
In the nine months ended December 31, 2008, cash provided by operating activities reflected an increase in non-cash working capital of $23.7 million. This increase in working capital was primarily due to:

- $13.8 million reduction in payables and accrued liabilities relating to refit and maintenance and other operating activities;
- $3.6 million reduction in regulatory liabilities reflecting the return to customers through discount fare promotions of the tariff revenues collected in excess of price caps in the last quarter of fiscal 2008;
- $3.3 million increase in prepaid expenses primarily due to increases of:
  - $3.1 million in prepaid fuel; and
  - $0.3 million in insurance and other contracts;
- $1.7 million reduction in accrued employee costs;
- $1.5 million reduction in deferred revenue; and
- $1.4 million reduction in interest payable due to timing of interest payments.

The above items, which increased working capital, were partially offset by:

- $1.1 million reduction in accounts receivable resulting from:
  - $3.3 million reduction in commercial travel cards receivable due to lower usage resulting from reductions in commercial traffic and seasonality;
  - $1.3 million reduction in GST receivables primarily due to the receipt of $0.8 million GST on import duties remission for the *Northern Adventure*; and
  - $0.2 million reduction in other receivables.

  These reductions were partially offset by increases of:
  - $3.7 million in receivables from the Province for social program fees, ferry transportation fees, fuel costs for the northern routes and amounts owing under the fare reduction and service restoration agreement; and
- $0.5 million reduction in total inventories.

Cash provided by financing activities reflects issuance of the second $90 million loan agreement with KfW, the $140 million Series 08-2 bond issuance, and $53 million draws on our $155 million credit facility during the nine month period. These draws were repaid in January 2009 as the instruments matured.

Cash used in investing activities consists mainly of $345.7 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, 2008 totalled $58.2 million ($304.3 million in the nine months ended December 31, 2008). 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, 2008 were:

	December 31, 2008	
($ millions)	3 Months	9 Months
New vessels, vessel upgrades and modifications	43.5	252.7
Terminal marine structures	6.6	23.5
Terminal and building upgrades and equipment	4.2	19.6
Computer hardware and software development	3.9	8.5
Total Capital Expenditures	58.2	304.3

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, 2008 included the following:

	December 31, 2008	
($ millions)	3 Months	9 Months
New *Coastal Inspiration* and *Coastal Celebration*	4.1	149.0
Life extension of the *Queen of New Westminster*	7.1	35.1
New intermediate vessel, the *Island Sky*	23.3	24.8
New northern vessel, the *Northern Expedition*	1.8	18.4
Upgrade and replacement of propulsion and safety equipment on the *Quinitsa*	0.0	6.0
Refurbishment of car deck on the *Powell River Queen*	0.0	5.2
Structural, electrical and mechanical upgrades on the *Quinsam*	3.3	3.4
Sewage treatment plant upgrade program	0.2	2.4
Structural and mechanical upgrades on the *Northern Adventure*	1.1	2.3
Ship to shore communication upgrades involving voice and data connectivity	0.7	1.5
Other projects	1.9	4.6
	43.5	252.7

Major Vessel Upgrades

The *Queen of New Westminster*, which formerly operated on our Duke Point–Tsawwassen route, is currently undergoing a project to extend the life of the 44-year-old vessel for a further 13 years of 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 early 2009 and be redeployed on our Tsawwassen–Swartz Bay route.

The *Quinsam*, which operates on our Nanaimo-Gabriola Island route, is currently undergoing the first phase of a $17.7 million upgrade project that will extend its life for a further 19 years of service. The upgrade project on the 26-year-old vessel will include structural and mechanical improvements as well as new lifesaving systems; new right angle drives; and improved passenger lounges and crew areas. The first phase is expected to be complete in the spring of 2009 at which time the *Quinsam* will return to service. The second phase is scheduled for October 2009 through March 2010.

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 are the largest double-ended vessels in the world. Each vessel measures 160 metres in length and accommodates up to 1,650 passengers and crew and approximately 370 vehicles. These new vessels feature a diesel-electric propulsion system that is one of the largest and most economical of its kind in the world. This propulsion system and other technological and environmental features of the *Coastal Renaissance* contributed to winning the prestigious ShipPax award for outstanding ferry technology for 2008. These Super C-class vessels are replacing aging vessels that have been providing service on our major routes.

The contracts with FSG were design-build and fixed price, totalling $325 million. The contracts have provided 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, formed the majority of the total project budget of $542 million. We are currently seeking a remission and refund of the import duties and related GST paid of approximately $86 million, but are uncertain as to the outcome of this application. The project for these three new state-of-the-art vessels came in on schedule and under budget.

Construction of the *Coastal Renaissance* started in August 2006 and the vessel was launched in Germany in April 2007. It commenced service on the Departure Bay-Horseshoe Bay route on March 8, 2008, following crew training and familiarization in the operation of this new vessel.

Construction of the *Coastal Inspiration* commenced in November 2006 and the vessel was launched in August 2007. On June 16, 2008, it commenced service on the Duke Point-Tsawwassen route, following crew training and familiarization.

Construction of the *Coastal Celebration* began in April 2007 and the vessel was launched in December 2007. It commenced service on the Swartz Bay-Tsawwassen route on November 21, 2008, following crew training and familiarization.

Northern Expedition

In July 2006, we signed a $133 million contract with FSG to build a new vessel which is expected to replace the 42-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, has 55 staterooms and will accommodate up to 130 vehicles and 600 passengers. The import duties and taxes on this contract will total approximately $43 million. We are seeking a remission of the import duties and related GST of approximately $35 million, but are uncertain as to the outcome of our 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 *Northern Expedition* departed Germany for the 10,000 nautical mile journey to British Columbia on January 30, 2009 and is expected to enter service in the spring of 2009.

Island Sky

On December 5, 2008, 243 days later than the contractual delivery date of April 6, 2008, we took delivery of the *Island Sky*, our new intermediate class ferry. The $47 million contract with Vancouver Shipyards constituted the majority of the total project budget of $57 million. The new intermediate vessel has allowed for the retirement and sale of the 48-year-old *Queen of Tsawwassen*. The 102-metre vessel, which is expected to be in service in the spring of 2009, will accommodate up to 600 passengers and 125 vehicles. It features a new state-of-the-art lifesaving system as well as a variety of amenities, including a lounge and snack bar for passengers.

Terminal Marine Structures

We continued to reinvest in our terminal infrastructure during the nine months ended December 31, 2008. We made significant upgrades to many of our terminals and made preparations for the arrival of the new Super C-class vessels and the *Northern Expedition*. Over the next five years, we plan to invest approximately $200 million in our terminals for building and marine structure upgrades.

Capital expenditures on terminal marine structures for the periods ending December 31, 2008 included the following:

($ millions)		December 31, 2008	
Terminal	Description	3 Months	9 Months
Prince Rupert	New pontoon, ramp, ramp abutment and dolphin[2]	2.2	6.2
Skidegate	New pontoon, ramp, ramp abutment and two dolphins	1.5	5.0
Bear Cove	New pontoon, ramp and ramp abutment	1.3	4.0
Duke Point	Berth upgrades to accommodate Super C-class vessels	0.1	2.2
McLoughlin Bay	Modifications to existing pontoon and new floating lead	0.7	1.2
Various	Other projects	0.8	4.9
		6.6	23.5

Marine upgrades at Skidegate, Prince Rupert, Bear Cove and McLoughlin Bay have a total budget of $31 million of which $7.5 million was completed in the prior year. These upgrades are expected to be completed by spring 2009 to correspond with the in-service date for the *Northern Expedition*. We have made every effort to ensure minimal service disruption for affected communities; however, it was necessary to temporarily suspend the Prince Rupert–Skidegate ferry service for a period of three weeks. We provided tug, barge and plane services to and from the Queen Charlotte Islands during this time.

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

Terminal and Building Upgrades and Equipment

In addition to upgrades to terminal marine structures, many other terminal upgrades are underway to provide better service to our customers and improve operational efficiencies. Capital expenditures on terminal and building upgrades and equipment included the following:

	December 31, 2008	
($ millions)	3 Months	9 Months
Departure Bay terminal	1.8	12.4
Security upgrades	1.1	2.0
Swartz Bay terminal	0.3	0.9
Alliford Bay / Skidegate erosion control	0.0	0.7
Richmond warehouse	0.2	0.5
Other terminal projects	0.8	3.1
	4.2	19.6

The most significant activity during the nine months ended December 31, 2008 has been at our Departure Bay terminal. A new retail building, the Departure Bay Quay, and new ticket building have been completed and the intersection realigned. The holding compound, pick-up and drop-off area, and the short-term parking are being expanded and a new waiting room and washrooms will be built.

At Swartz Bay terminal, the holding compound and pre-ticket area have been expanded, new ticket booths built, the radar maintenance building relocated and the exit realigned. In fiscal 2010, we will improve our waste water treatment by building independent equalization storage facilities, a pumping station and a connection to a local unified treatment plant.

At nine terminals, mainly serving our major and northern routes, we continue our multi-year project to upgrade our security. This project primarily involves fencing, gating, lighting, access controls and closed circuit television as well as upgrades to foot passenger ticketing areas and baggage screening. In January 2009, Transport Canada, through the Marine Security Contribution Program, approved approximately $5.5 million of federal funding to help offset our costs of perimeter security, access control measures, and training. These funds are in addition to the $3.8 million previously approved under this program.

Information Technology

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

Other ongoing projects include enhanced reporting initiatives, better external and internal communications, replacement of obsolete technology, and security projects. These projects focus on obtaining efficiencies, improving safety and security, and providing better service to our customers.

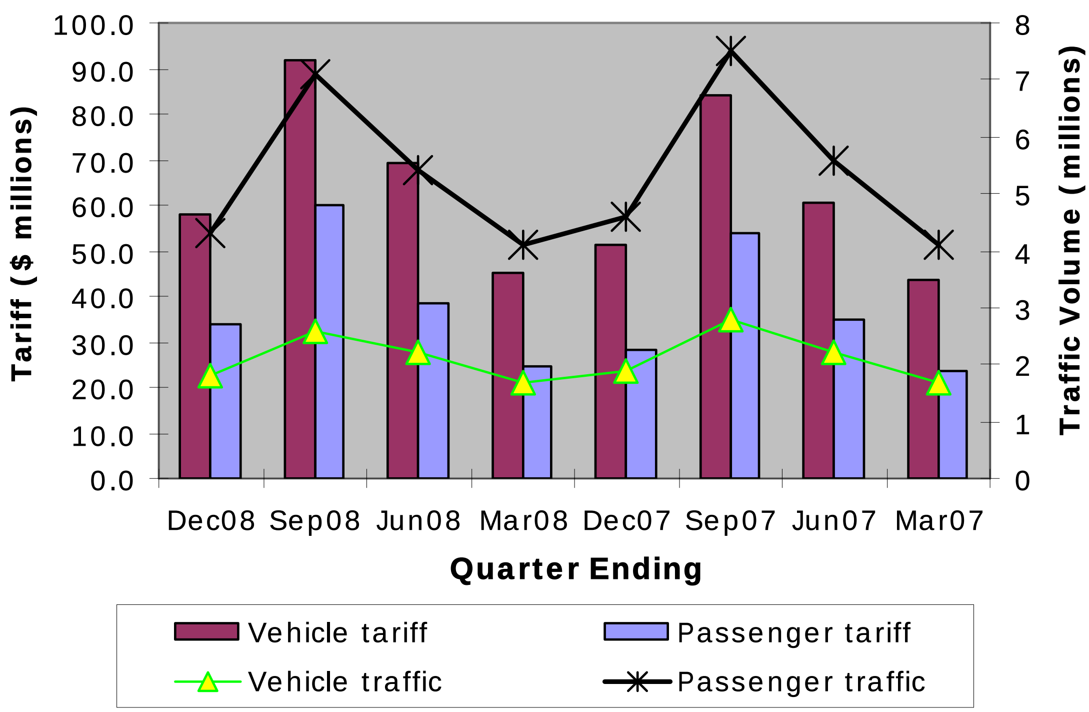
SUMMARY OF QUARTERLY RESULTS

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

	Quarter Ended (unaudited)							
($ millions)	Dec 08	Sep 08	Jun 08	Mar 08	Dec 07	Sep 07	Jun 07	Mar 07
Total revenue	149.4	232.1	171.9	124.2	136.5	220.2	159.8	119.0
(Loss) earnings from operations	(1.7)	66.2	18.3	(20.0)	(0.4)	69.4	22.1	(27.7)
Net (loss) earnings and comprehensive income	(14.6)	53.7	8.4	(30.5)	(7.8)	61.0	14.4	(33.2)

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

Economic Outlook

The Canadian economy is not immune to the current turbulence in financial markets and the deepening recession in major economies around the world. This has had a negative impact on our operations. While our ridership has been stable over several years, we are experiencing a downturn in traffic which is at least in part due to the current economic condition. This year, British Columbia is experiencing lower housing starts, plant closures in the forest product industry, falling auto sales, rising unemployment, and generally reduced consumer spending. These and other declining economic conditions have all negatively impacted our commercial and discretionary travel markets. The duration of this recession is uncertain and we believe it is unlikely that the impact on our operations will reverse until such time as world and local economies begin to recover.

Fuel Costs

Fuel is a major cost of our operations. Fuel oil prices have fluctuated significantly during the past year after increasing dramatically over the past few years and there is uncertainty of future pricing. We are exposed to risks associated with the volatility of the market price of fuel which we manage by entering into swap agreements in order to add a fixed component to the inherent floating nature of fuel prices. Fuel price hedging instruments are used solely for the purpose of reducing fuel price risk, not for generating trading profits. Our fuel price risk management policy limits hedging to a maximum of 95% of anticipated monthly fuel consumption for the immediately following 12 month period; a maximum of 90% of anticipated monthly fuel consumption for the 12 month period thereafter; and a maximum of 85% of anticipated monthly fuel consumption for the period thereafter to the end of the second performance term ending March 31, 2012. At December 31, 2008, we held 20 swaps that will mature prior to the end of February 2010. These fix approximately 70% of our anticipated fuel costs for the next year. Gains and losses resulting from fuel forward contracts are recognized as a component of fuel costs.

To mitigate the effect of volatility in fuel oil prices on our earnings, we use deferred fuel cost accounts.

For the northern routes, the per litre cost of fuel included in the determination of price caps (the set price) and one-half of the first 5 cents per litre of difference between the actual price paid per litre (including realized hedge gains and losses) and the set price are recorded in expense. The remaining one-half of the first 5 cents per litre of difference is recorded in the deferred fuel cost accounts. Any difference beyond 5 cents per litre is recovered from or paid to the Province. The total to be recovered from the Province relating to fuel costs on the northern routes was $2.6 million for the nine months ended December 31, 2008.

For all other routes, differences in fuel costs arising from our actual price paid per litre (including realized hedge gains and losses) being higher or lower than the unit set price included in base tariffs less one-half of the first 5 cents per litre of difference are charged or credited to the deferred fuel cost accounts.

The balances in our deferred fuel cost accounts totalled $20.8 million at December 31, 2008 ($11.9 million at March 31, 2008). Included in the December 31, 2008 balance is $7.8 million in unrealized fuel hedge losses on fuel forward contracts entered into to fix the price of future purchases. Also included in the balance is a reduction of $1.3 million reflecting three quarters of the agreed $1.7 million annual payment from the Province.

In performance term one, to reduce the increasing balances of the deferred fuel cost accounts, the Commissioner approved extraordinary price cap increases to allow for fuel surcharges which were implemented from time to time, beginning in July 2005. In performance term two, there is a mechanism in place to allow price cap increases to provide for implementation of fuel surcharges. The mechanism also provides for fuel rebates when appropriate.

As a result of dramatically rising fuel costs over the first four months of the fiscal year, we received approval from the Commissioner to allow for the early implementation of fuel surcharges, effective August 1, 2008, on all but the northern routes. Subsequently, fuel prices dropped and we obtained approval to first reduce these fuel surcharges by 50% effective November 4, 2008 and further eliminate all remaining fuel surcharges to reflect the continuing drop in fuel prices. All remaining fuel surcharges were removed on December 19, 2008 on the major routes and December 5, 2008 on all other routes. Fuel rebates of up to 5% will be implemented on the other routes in February 2009. At this time we cannot offer fuel rebates on the major routes due to the negative balances in the deferred fuel cost accounts.

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 economy, demographics and population growth.

On October 22, 2008, the Province announced that it would provide funding to allow a 33% reduction on fares for all routes during the months of December 2008 and January 2009 and for our Prince Rupert-Skidegate route during February 2009. This was expected to have a positive effect on traffic levels.

In the month of December, traditionally a busy month, we experienced a decrease of 10% in traffic from the prior year largely due to severe weather. For three weeks, our service areas were faced with high winds, record snowfalls, black ice, freezing rain and impassable roads.

In all three quarters of fiscal 2009, we have experienced a decrease in traffic compared to the prior year. Vehicle traffic was 7.6% lower in the third quarter (5.1% year-to-date) and passenger traffic was 5.9% lower (4.5% year-to-date).

With the fluctuations in transportation costs as a result of volatile fuel prices, the tariff rate increase of April 1, 2008, implementation and removal of fuel surcharges and the current economic uncertainties, we are uncertain as to the cumulative impact these events may have on our traffic. As a result of this uncertainty and of the continued reduction in traffic through the third quarter, we have taken significant measures to reduce overall overhead and other operating costs from previously planned levels.

Corporate Restructuring

Due to the continuing decline in traffic levels and resulting revenues, we have determined the need to restructure our business to align expenses with reduced revenues while continuing to ensure that safety remains our top priority. This restructuring is in addition to our other cost savings measures that include deferral of filling staff vacancies and deferring or reducing travel, consulting, marketing, advertising and other discretionary expenditures. To date, we have released approximately 35 management and administrative personnel, including several senior management and director level employees. While no front line or ship based employees are directly impacted at this time, further changes and possible lay-offs are anticipated in shore based positions, including unionized staff positions. These proactive measures, along with other initiatives, are expected to reduce our operating expenditures by approximately $14 million from previously planned levels in fiscal 2010.

Safety and Environmental Protection

The safety of the public and our employees and the protection of the environment are our highest priorities. Part of our safety plan was to increase the level of annual operational training we conduct. We increased training from approximately 11,000 person days in fiscal 2007 to 14,200 in fiscal 2008 and plan a similar level for fiscal 2009. To the end of December 31, 2008, we have completed 11,000 person training days.

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. In the first phase of the action plan, we expect to implement 48 recommendations, of which 17 are complete at the end of December 2008. The success of this program is evident in a significant reduction of time-loss injuries in the nine months ended December 31, 2008, compared to the same period in the prior year.

We are proactive in ensuring environmental regulations are met or exceeded and in developing strategies that demonstrate our commitment to sound 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;
- replacing gasoline powered terminal vehicles with electric vehicles; and
- replacing gasoline powered baggage vans with propane powered tugger units.

We have a fuel reduction strategy that is designed to improve fuel efficiency and reduce emissions from 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
We have one of the largest fleets in the world. The average age of our assets was among the oldest of major ferry operators worldwide. To address this, we instituted a major fleet and asset renewal program. The additions to our fleet have been:

- the *Northern Adventure* and the *Kuper* in March 2007; and
- the Super C-class vessels: the *Coastal Renaissance,* the *Coastal Inspiration*, and the *Coastal Celebration* in March, June and November 2008, respectively.

In the spring of 2009, the *Northern Expedition*, a northern vessel, and the *Island Sky*, an intermediate class ferry, are expected to enter service.

Upgrading and replacing a large share of our fleet through new vessel acquisitions and our revitalization program will also 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.

Market Opportunities
Notwithstanding the pressure on traffic volumes generally, we see opportunities for growth in certain segments of our business.

In March 2007, we established Pacific Marine Ventures Inc. (PMV) as a wholly owned subsidiary to pursue strategic business opportunities related to commercial traffic, tourism, and terminal management. In September 2007, PMV assumed management of the Sidney International Ferry terminal. Under a 40-year lease, PMV is managing and developing the town's ferry terminal with a focus on developing new business opportunities. Washington State Ferries continues to be the primary user of the facility with its service to Anacortes, Washington. PMV is also pursuing other opportunities.

To increase our profile in the Lower Mainland, expand our new market reach, and further develop travel and tourism partnerships, in February 2008 we signed an agreement to lease a 250 square metre travel centre in the new Fairmont Pacific Rim property currently under construction in downtown Vancouver. We anticipate our travel centre will open in late 2009.

During fiscal 2008, we realized a 12.5% increase in commercial traffic revenue compared to the previous year. To increase our capacity in the commercial sector, we have assigned one new Super C-class vessel to each major route between the Lower Mainland and Vancouver Island. Although we realized a 13.7% increase in commercial traffic revenue in the nine months ended December 31, 2008 compared to the prior year, the traffic volume fell by 8.2% in the third quarter. We have gained market share within the commercial sector in the third quarter, however the commercial market has declined, reflecting the closure of mills on Vancouver Island and significant reductions in the auto industry. Our commercial sales team is continuing to actively pursue new business and is implementing new integrated sales solutions and enhanced services for our commercial customers.

In September 2008, we established BCF Global Services Inc. (BCF Global) as a wholly owned subsidiary to provide consulting and management services both domestically and internationally. BCF Global will take advantage of our expertise and long history in the marine transportation business to pursue new business opportunities relating to the development, operation and maintenance of ferry systems.

Regulation

Transport Canada regulates the safety of our vessels by authority of the *Canada Shipping Act 2001,* which came into effect on July 1, 2007. This is the principal legislation which, together with regulations, governs the activities of Canadian vessels in all waters and all vessels in Canadian waters. The revised regulations may have an impact on the requirement for vessel upgrades. On January 1, 2009, a new Transport Canada requirement took effect whereby each domestic ferry must have a minimum safe manning document. This document dictates the minimum crew complement and crew certification required to operate the vessel at various passenger levels. To maintain existing passenger levels on our other routes an increase of approximately 12 positions would be required. The cost of this increase can be mitigated by lowering passenger licence levels; however, the Coastal Ferry Services Contract requires us to maintain a minimum passenger capacity. An analysis of our options in this regard is currently underway. We also continue to address the new regulations through our planning processes and asset renewal initiatives. 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. Amendments to the existing regulations have been proposed, the intent of which is to include domestic ferries and facilities within the *Marine Transportation Security Act* framework. If these amendments are enacted, 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. 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 completed location-specific security plans on the major routes and northern routes that are required to comply with the regulations.

In January 2009, Transport Canada, through the Marine Security Contribution Program, approved approximately $5.5 million of federal funding to help offset our costs of perimeter security, access control measures and training. This program allows for reimbursement of 75% of the costs of security enhancements on approved projects. Under our first submission, $3.8 million was approved of which we have incurred costs and applied for reimbursement of approximately $1.5 million.

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 ended March 31, 2008 and our second performance term ends March 31, 2012. The core ferry transportation fees and service levels for the second term have been set and the Commissioner released a final second performance term price cap order. Under this order, the price cap increase (starting from a level which includes fuel surcharges in place at March 31, 2008) was 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. The price caps will increase by 3.74% on the major routes and 7.25% on all other routes on April 1, 2009.

Competition

New competitors have emerged in both the passenger-only market and the commercial traffic market in the past few years. To date, a number of passenger-only competitors have not been successful at sustaining operations.

We have competition in the commercial sector, where three companies, including ourselves, are 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 have increased capacity for both commercial and passenger vehicle traffic on our major routes with the assignment of a Super C-class vessel to each route. We have also improved traffic efficiency at the Horseshoe Bay terminal and are continuing with improvements at the Departure Bay terminal. We have gained market share within the commercial sector in the third quarter, however the commercial market has declined, reflecting the closure of mills on Vancouver Island and significant reductions in the auto industry. We are continuing to investigate new service offerings within this sector.

In an effort to reduce costs on our regulated routes and as mandated by the *Coastal Ferry Act*, we are exploring opportunities to have ferry services provided by 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 us, could provide safe, reliable and high quality service that is more cost-effective.

A Request for Proposal (RFP) process was completed for the Brentwood Bay-Mill Bay route. We performed an extensive assessment of the proposal received from an alternative service provider and an external, independent party was engaged to review our evaluation. It was concluded that we can operate this route in a more cost-effective manner than that proposed by the potential alternative service provider and we continue to be the service provider for this route.

In August 2008, we issued a Request for Expressions of Interest (RFEOI) as the first step in the process for seeking an alternative service provider for the Campbell River–Quadra Island, Quadra Island–Cortes Island, and Port McNeill–Sointula–Alert Bay routes. No respondent to the RFEOI has elected to proceed, completing the process. We will continue to be the provider of service on these routes. We expect to issue an RFP 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.

The carrying value and fair value of our non-derivative financial instruments by class and of our derivative instruments by type are included in note 10 of our interim consolidated financial statements.

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 2008 annual Management's Discussion & Analysis. Although our risk profile is substantially unchanged during the nine months ended December 31, 2008, below are risks not discussed elsewhere in this document that we are managing in the current uncertain economic environment.

We do not believe that material uncertainties exist in regards to our future. We have considered many items such as profitability levels, cash generating potential, cash utilization requirements including debt repayment schedules and future capital expenditures, and working capital requirements. We have taken measures to allow us to weather the economic downturn and continue to have a viable, profitable future.

Credit Risk

We limit our credit risk on cash and investments by investing in liquid securities with high credit-quality counter-parties, placing limits on tenor of investment instruments and instituting maximum investment values per counter-party. We manage credit exposure related to financial instruments by dealing with high credit-quality institutions, in accordance with established credit-approval practices and by an ongoing review of our exposure to counter-parties. We do not expect any counter-parties to default on their obligations.

Our credit risk from trade customers is limited by having a large and diversified customer base and is managed through the review of third party credit reports, utilizing pre-authorized payment plans, monitoring of aging of receivables, and collecting deposits and adjusting credit terms for higher-risk customers. Amounts due from the Province are considered low credit risk. At December 31, 2008, 80% of our accounts receivable was comprised of amounts due from the Province.

Interest Rate & Foreign Currency

Our exposure to interest rate risk is limited to our short-term borrowings and floating rate debt and interest rate movement beyond the term of the maturity of the fixed rate investments. To manage this risk, we maintain between 70% and 100% of our debt portfolio in fixed rate debt, in aggregate. We are also exposed to risk from foreign currency prices on financial instruments, such as accounts payable denominated in currencies other than the Canadian dollar. To manage exposure on future purchase commitments, we review our foreign currency denominated commitments and hedge through derivative instruments as necessary. A 50 basis point change in interest rates or a 10% change in the US dollar or Euro foreign exchange rates would not have had a significant effect on our earnings for the nine months ended December 31, 2008.

The management of the credit, liquidity and market risk arising from our financial instruments is discussed in detail in note 9 of our interim consolidated financial statements.

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, 2008 and December 31, 2008 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 40 through 42 of our fiscal 2008 Management's Discussion & Analysis. The following describes the changes to critical accounting policies we have used in the preparation of our consolidated financial statements for the nine months ended December 31, 2008 or expect to use in the future.

Adoption of New Accounting Standards

Effective April 1, 2008, we adopted the following CICA Handbook Sections:

- 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. Other than the additional disclosure in note 11, the adoption of this section has had no 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. Other than the change in disclosure in Note 1, the adoption of this section has had no 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. Other than the additional disclosure in notes 9 and 10, the adoption of this section has had no impact on our consolidated financial statements.

- Section 3863, *Financial Instruments – Presentation* carries forward existing requirements on presentation of financial instruments. Application of this section did not have any impact on our consolidated financial statements.

Future Accounting Changes
We have not yet adopted the following CICA Handbook Sections which will be effective for us beginning April 1, 2009:

- Section 3064, *Goodwill and Intangible Assets* does not substantively change the requirement pertaining to goodwill. The changes in requirements pertaining to intangible assets primarily relate to recognition criteria for purchased and internally developed assets which will result in fewer intangible assets being recognized on the balance sheet. We are continuing to assess the financial reporting impact of the adoption of this section.

- Amendments to Sections 1100 *Generally Accepted Accounting Principles*, 3465 *Income Taxes* and Accounting Guideline AcG-19 *Disclosures by Entities Subject to Rate Regulation* are to be applied prospectively. 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 future income tax 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.

In 2006, the Canadian Accounting Standards Board (AcSB) published a new strategic plan that will significantly affect financial reporting requirements for Canadian companies. The AcSB strategic plan outlines the convergence of Canadian generally accepted accounting principles with International Financial Reporting Standards (IFRS) over an expected five year transitional period. During March 2008, the AcSB confirmed the transition dates for conversion to IFRS. Our transition date for the conversion to IFRS is April 1, 2011 and will require the restatement for comparative purposes of amounts reported by us for the year ended March 31, 2011. We are continuing to assess the financial reporting impacts of the adoption of IFRS and, at this time, the impact on the future financial position and results of operations is not reasonably determinable or estimable.

We commenced our IFRS conversion project in 2007 and have established a formal project governance structure with regular reporting. We have also engaged a quality assurance advisor to assist in the project.

Our IFRS conversion project consists of three phases: scoping and diagnostic; analysis and development; and implementation and review. The first phase, which has been completed, involved project planning and resourcing, identification of differences between current Canadian GAAP and IFRS and priority setting. The areas identified to have the highest potential to significantly impact us are rate regulated operations, property plant and equipment, intangible assets and asset impairment, and initial adoption of IFRS under the provisions of IFRS 1 *First-Time Adoption of IFRS*.

The second phase, which involves detailed analysis and evaluation of options and alternative methodologies available under IFRS and the financial impact of these options, is currently in progress. We anticipate that the adoption of IFRS will have an impact on our system requirements; however the degree of impact is not reasonably determinable at this stage of the project. We will continue to closely monitor the proposed and continuing projects of the International Accounting Standards Board and any International Financial Reporting Interpretations Committee initiatives that may potentially impact rate regulated accounting under IFRS.

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. Some of the market conditions and factors that have been considered in formulating the assumptions upon which forward looking statements are based include traffic, the Canadian Dollar relative to the US Dollar, fuel costs and the fuel reduction program, construction costs, the state of the local economy, turbulent financial markets, demographics, import duties remission, GST reduction, and the requirements of the Coastal Ferry Services Contract.

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, safety and security, asset risk, accident 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.