

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

**For the three and six months ended September 30, 2009
Dated October 27, 2009**



Table of Contents

BUSINESS OVERVIEW	1
FINANCIAL AND OPERATIONAL OVERVIEW	3
Revenue.....	4
Major Routes	5
Northern Routes	6
Other Routes	8
Expenses	10
Liquidity and Capital Resources	12
Sources & Uses of Cash.....	12
INVESTING IN OUR CAPITAL ASSETS.....	14
Terminal and Building Upgrades and Equipment.....	14
New Vessels, Vessel Upgrades and Modifications	15
Information Technology	16
Terminal Marine Structures	16
SUMMARY OF QUARTERLY RESULTS	17
FINANCIAL RISKS AND FINANCIAL INSTRUMENTS	18
BUSINESS RISK MANAGEMENT.....	18
ACCOUNTING PRACTICES.....	18
Critical Accounting Policies and Estimates	18
Adoption of New Accounting Standards	18
Future Accounting Changes	19
FORWARD LOOKING STATEMENTS	22

**Management's Discussion & Analysis
of Financial Condition and Results of Operations
For the three and six months ended September 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 September 30, 2009. This should be read in conjunction with our unaudited interim consolidated financial statements and related notes for the three and six month periods ended September 30, 2009 and 2008, and our annual audited consolidated financial statements and related notes together with our fiscal 2009 Management's Discussion & Analysis. These documents are available on our Investor webpage at <http://www.bcferrys.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 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 British Columbia.

We are a versatile company, providing a wide range of ferry services for our customers. During the three months ended September 30, 2009 (the second quarter of fiscal 2010), we provided over 48,000 sailings, carrying 7.2 million passengers and 2.7 million vehicles.

Our traffic levels have historically been relatively stable. However, the recent decrease in global economic activity, the lower level of international tourism and higher level of unemployment have negatively impacted discretionary travel. During fiscal 2009, vehicle and passenger traffic were lower than the prior year by 5.2% and 4.9%, respectively. In the first quarter of fiscal 2010, we experienced a further decline of 1.0% in vehicle traffic and 0.4% in passenger traffic as compared to the same period in the prior year.

In the second quarter of fiscal 2010, there was an improvement in both vehicle and passenger traffic over the same period in the prior year, with increases of 4.3% and 1.7%, respectively. For the six months ended September 30, 2009, vehicle traffic was 1.9% higher and passenger traffic was 0.8% higher than the first six months of fiscal 2009.

We continue to review and update our financial and operating plans in response to current economic conditions. Over the near term, we anticipate the limited recovery in local discretionary traffic levels to continue. We also expect commercial traffic to continue to improve this fiscal year as we gain market share with our new drop-trailer service and as the economy begins to recover.

In March 2009, we launched our drop-trailer service. We now offer a new service to commercial customers on two of our Major Routes. Our commercial customers on these routes can now drop their trailers off at one terminal and pick them up at another. This drop-trailer service has been well received in the commercial market and improves our overall productivity by utilizing otherwise unused capacity.

We continue to assess the feasibility of enhancing our northern service to Prince Rupert by commencing periodic service from our Tsawwassen terminal on the Lower Mainland to our Port Hardy terminal on Vancouver Island with the objective of increasing tourism and providing enhanced service to our existing customers. We are currently consulting with governments, communities, businesses and the travel and tourism sector.

During the quarter, we hosted an open house and public meeting to provide information regarding our review of the feasibility of using cable ferry technology on one of our shortest routes. This initiative is part of our ongoing efforts to identify and pursue opportunities that have the potential to enhance our effectiveness in delivering safe, reliable and quality ferry service. Cable ferry technology uses small engines in combination with drive and guide cables to move the vessel. Not only do cable ferries have a lower capital cost than conventional ferries but there is also potential for a reduction in operating costs.

Significant events during or subsequent to our second quarter of fiscal 2010:

- On June 12, 2009, we issued a Request for Proposal (RFP) to identify prospective alternative service providers who have the means, qualifications and experience to provide service to the mid-coast ports of Ocean Falls and Shearwater on our Northern routes. The RFP closed in July 2009 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 for this service by the end of November 2009.
- From July 7 to September 10, 2009, we offered our popular "CoastSaver" program. This promotional fare incentive program provided mid-week price discounts of approximately one third on passenger and passenger vehicle fares on our Major Routes.
- On July 15, 2009, fares were reduced as fuel rebates were increased from 5% to 8% on many of our routes. On September 1, 2009, the fuel rebates were further increased to 10% on these routes.
- On July 28, 2009 the Province announced that it was launching a review of the operations of certain independent agencies, including British Columbia Ferry Services Inc. We provided all information requested from us by the office of the Comptroller General. The Comptroller General's report, which made a number of recommendations to the Province on governance, was released on November 6, 2009. We are currently reviewing the report.
- On September 24, 2009, the provincial government announced that, as part of the federal government's Infrastructure Stimulus Fund program, BC Ferries will qualify for partial reimbursements of eligible costs of eight sewage pump-ashore and waste water treatment projects, as well as other terminal projects. The net funding expected to be received is \$7.5 million. (See Investing in our Capital Assets below for more project detail)

FINANCIAL AND OPERATIONAL OVERVIEW

This section provides an overview of our financial and operational performance for the three and six months ended September 30, 2009 and 2008.

(\$ millions)	Three months ended September 30			Six months ended September 30		
	2009	2008	Variance	2009	2008	Variance
Total revenue	251.8	232.1	19.7	430.1	404.0	26.1
Expenses	(170.3)	(165.9)	(4.4)	(336.4)	(319.4)	(17.0)
Earnings from operations	81.5	66.2	15.3	93.7	84.6	9.1
Interest and other	(17.3)	(12.5)	(4.8)	(33.1)	(22.5)	(10.6)
Net earnings and comprehensive income	64.2	53.7	10.5	60.6	62.1	(1.5)

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 and we utilize these off-peak periods to perform upgrades and major maintenance and refit programs, as well as to undertake mandatory inspections on the majority of our vessels.

Our earnings from operations in the three months ended September 30, 2009, were \$15.3 million (\$9.1 million year-to-date) higher than the three months ended September 30, 2008. Net earnings were \$10.5 million higher (\$1.5 million lower year-to-date) than the same period in the prior year.

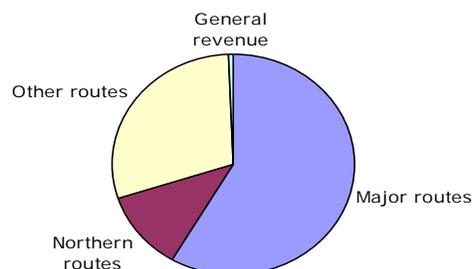
Our ridership improved in the second quarter with an increase over the same period of the prior year of 4.3% for vehicles and 1.7% for passengers. During the six months ended September 30, 2009, our ridership was 1.9% higher for vehicles and 0.8% higher for passengers compared to the same period of the prior year.

As expected, costs of amortization and financing increased significantly as a result of new capital assets entering service as we near the completion of our fleet and asset renewal program for our Major and Northern Routes. Although operating expenses increased in the quarter from a year ago, we undertook a major program to constrain them such that the increase in revenue from higher traffic levels was able to improve our year to date net earnings to a level slightly below those of the previous year.

Revenue

Our total revenues for the three and six months ended September 30, 2009 increased over the same period in the previous year as shown in the table below.

In the six months ended September 30, 2009, the greatest portion of our revenues, 58%, was earned on our three Major Routes connecting Vancouver Island to Vancouver and the Lower Mainland. The revenue from the Northern Routes contributed 12% and Other Routes contributed 29%.



Revenue (\$ millions)	Three months ended September 30			Six months ended September 30		
	2009	2008	Increase (Decrease)	2009	2008	Increase (Decrease)
Direct Route Revenue						
Vehicle traffic (volume)	2,705,611	2,593,155	112,456	4,838,459	4,747,153	91,306
Vehicle tariff	98.6	91.8	6.8	166.3	161.3	5.0
Passenger traffic (volume)	7,244,306	7,125,479	118,827	12,636,109	12,536,475	99,634
Passenger tariff	62.8	60.2	2.6	103.1	98.7	4.4
Social program fees	5.6	6.0	(0.4)	11.7	11.4	0.3
Catering & on-board	27.8	26.5	1.3	47.2	45.8	1.4
Other revenue	9.3	8.2	1.1	14.0	13.3	0.7
Total Direct Route Revenue	204.1	192.7	11.4	342.3	330.5	11.8
Indirect Route Revenue						
Ferry transportation fees	39.9	31.8	8.1	72.1	58.1	14.0
Federal-Provincial subsidy	6.7	6.6	0.1	13.5	13.1	0.4
Total Route Revenue	250.7	231.1	19.6	427.9	401.7	26.2
Other general revenue	1.1	1.0	0.1	2.2	2.3	(0.1)
Total Revenue	251.8	232.1	19.7	430.1	404.0	26.1

Our largest revenue source is vehicle and passenger tariffs. Effective April 1, 2009, the British Columbia Ferries Commissioner (the Commissioner) authorized a price cap increase of 3.74% on the Major Routes and 7.25% on all other routes. In response, we implemented tariff increases up to the new level authorized. On each subsequent April 1 of the four-year performance term ending March 31, 2012, the Major Route price cap will increase by 2.7% plus 0.49 times the British Columbia Consumer Price Index (CPI). On the other routes, the price cap will increase by 5.7% plus 0.73 times the British Columbia CPI.

From time to time, we utilize promotional fares designed to stimulate growth in traffic or to 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 adjustments resulting from being over or under the price cap in previous periods may cause the average vehicle and passenger tariff rate to vary from the allowed increase in any one period.

At April 1, 2009, fuel rebates of up to 5% of tariffs were in place on routes other than our major and northern routes. As a result of a continuing decline in fuel prices, fares were further reduced as average rebates were increased to 8% on July 15, 2009, and to 10% on September 1, 2009 on these routes. No rebates are in place on our Major and Northern Routes.

Year to year changes for the three and six months ended September 30 for the Major, Northern and Other Routes are discussed separately below.

Major Routes

Direct Route Revenue (\$ thousands)	Three months ended September 30			Six months ended September 30		
	2009	2008	Increase (Decrease)	2009	2008	Increase (Decrease)
Vehicle traffic (volume)	1,291,686	1,216,591	75,095	2,253,837	2,194,054	59,783
Vehicle tariff	73,106	67,632	5,474	122,482	120,327	2,155
Passenger traffic (volume)	3,854,621	3,785,881	68,740	6,598,779	6,553,995	44,784
Passenger tariff	44,298	42,926	1,372	72,853	71,220	1,633
Social program fees	2,776	3,079	(303)	5,750	5,783	(33)
Catering & on-board	21,691	20,651	1,040	37,528	36,533	995
Reservation fees	4,870	4,782	88	7,570	7,822	(252)
Parking	1,259	1,131	128	1,897	1,886	11
Assured loading	934	693	241	1,406	1,181	225
Other revenue	1,321	765	556	1,721	1,073	648
Total Direct Route Revenue	150,255	141,659	8,596	251,207	245,825	5,382

Our Major Routes consist of three regulated routes connecting Greater Vancouver with mid and southern Vancouver Island.

Both vehicle traffic and passenger traffic increased in the three and six months ended September 30, 2009, compared to the same periods in the previous year. The increase in average tariff yield per vehicle in the second quarter was \$1.01 or 1.8% (\$0.50 or 0.9% decrease year-to-date). The increase in the second quarter is mainly as a result of an increase in commercial vehicles which carry higher individual fares. Our recently introduced drop-trailer service has been well received in the commercial market and we also experienced a partial recovery in other commercial traffic. The improvement in average yield in the second quarter and the increase in traffic resulted in a \$5.5 million (\$2.2 million year-to-date) increase in vehicle tariff revenue. The increase in average tariff yield per passenger in the second quarter was \$0.15 or 1.4% (\$0.17 or 1.6% year-to-date). The increase in passenger traffic and average yield resulted in a \$1.4 million (\$1.6 million year-to-date) increase in passenger tariff revenue.

Social program fees are reimbursements we receive from the Province for discounts that are provided on fares to BC seniors, students travelling to and from school, persons with disabilities and persons travelling under the Medical Travel Assistance Program. These fees were higher in the first quarter and lower in the second quarter of fiscal 2010 compared to the same periods in the prior year largely as a result of the timing of promotional fare incentives.

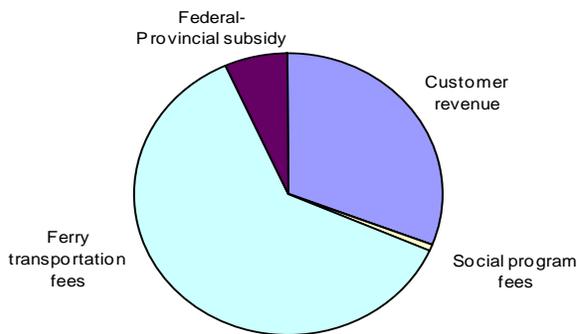
All of our vessels that provide service on our Major Routes have a gift shop and options for food service. In the three months ended September 30, 2009, both food and giftshop sales increased over the same period of the prior year as a result of a higher number of passengers and higher average spend per passenger.

Fees for assured loading and parking revenue increased in the second quarter as a result of higher traffic levels and are now higher than the prior year-to-date period. Reservation fees increased by 1.8% in the second quarter but continue to be lower than the prior year-to-date period. The increase in other revenue is mainly due to the timing of receipt of monthly retail rebates from a major sponsorship contract signed in the last quarter of fiscal 2009 and fees received from the Departure Bay Quay, which opened in July 2008.

Northern Routes

Direct Route Revenue (\$ thousands)	Three months ended September 30			Six months ended September 30		
	2009	2008	Increase (Decrease)	2009	2008	Increase (Decrease)
Vehicle traffic (volume)	15,923	16,114	(191)	23,352	24,123	(771)
Vehicle tariff	4,499	4,552	(53)	6,394	6,701	(307)
Passenger traffic (volume)	48,868	52,637	(3,769)	68,971	74,693	(5,722)
Passenger tariff	4,535	4,620	(85)	6,147	6,351	(204)
Social program fees	316	208	108	542	400	142
Catering & on-board	1,525	1,411	114	2,068	1,932	136
Reservation fees	26	32	(6)	40	47	(7)
Stateroom rental	491	431	60	732	628	104
Hostling ¹ & other	61	57	4	109	115	(6)
Total Direct Route Revenue	11,453	11,311	142	16,032	16,174	(142)
Indirect Route Revenue						
Ferry transportation fees	18,557	9,731	8,826	31,082	16,164	14,918
Federal-Provincial subsidy	1,665	1,626	39	3,330	3,252	78
Total Route Revenue	31,675	22,668	9,007	50,444	35,590	14,854

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



In the six months ended September 30, 2009, revenue from our Northern Routes consisted of 30% from customers and 70% from the Province (1% social program fees, 62% ferry transportation fees, and 7% 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, cont'd

Both vehicle traffic and passenger traffic decreased in the three and six months ended September 30, 2009, compared to the same period in the previous year. The average tariff yield per vehicle was the same in the second quarter ended September 30, 2009 and September 30, 2008, but declined \$3.98 or 1.4% year-to-date. This reflects a small improvement in the second quarter in commercial vehicle traffic which carries higher individual fares. The reduction in passenger traffic in the second quarter was partially offset by an increase in average tariff yield per passenger of \$5.03 or 5.7% (\$4.10 or 4.8% year-to-date). The lower traffic, changes in average vehicle tariff yield and increase in average passenger yield resulted in \$0.1 million less tariff revenue (\$0.5 million year-to-date).

Reimbursements from the Province for social program fees increased as a result of higher usage and higher average fares. Revenue from catering and on-board services has increased as a result of higher average passenger spend reflecting the entry into service of the new *Northern Expedition*, partially offset by lower traffic levels. Stateroom rental revenue has increased as a result of higher usage.

Hostling and other income are higher in the quarter primarily as a result of an improvement in commercial traffic.

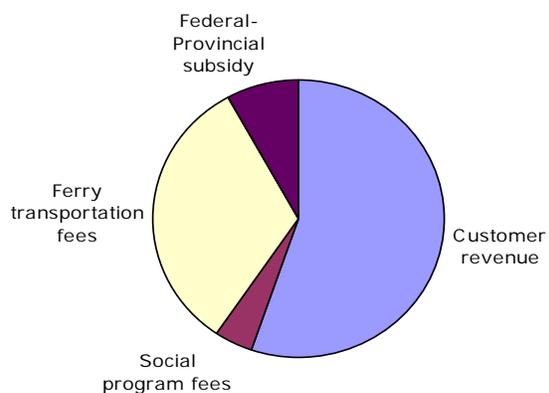
We receive ferry transportation fees for these routes under the Coastal Ferry Services Contract which relate, in part, to the capital cost of the vessels serving these routes. The fees have increased as a result of the capital cost of the new *Northern Expedition*, which commenced operating May 18, 2009, on our northern route through the Inside Passage from Port Hardy to Prince Rupert. The annual ferry transportation fees this fiscal year are expected to increase \$22.3 million or 88.2% to a total of \$47.6 million.

The total Federal-Provincial subsidy has increased by the Vancouver CPI.

Other Routes

Direct Route Revenue (\$ thousands)	Three months ended September 30			Six months ended September 30		
	2009	2008	Increase (Decrease)	2009	2008	Increase (Decrease)
Vehicle traffic (volume)	1,398,002	1,360,450	37,552	2,561,270	2,528,976	32,294
Vehicle tariff	21,038	19,647	1,391	37,461	34,243	3,218
Passenger traffic (volume)	3,340,817	3,286,961	53,856	5,968,359	5,907,787	60,572
Passenger tariff	13,862	12,617	1,245	24,044	21,148	2,896
Social program fees	2,593	2,692	(99)	5,449	5,224	225
Catering & on-board	4,033	3,969	64	6,837	6,704	133
Reservation fees	703	618	85	1,035	926	109
Parking & other	154	149	5	251	253	(2)
Total Direct Route Revenue	42,383	39,692	2,691	75,077	68,498	6,579
Indirect Route Revenue						
Ferry transportation fees	21,372	22,100	(728)	41,025	41,888	(863)
Federal-Provincial subsidy	5,066	4,947	119	10,132	9,895	237
Total Route Revenue	68,821	66,739	2,082	126,234	120,281	5,953

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 six months ended September 30, 2009 revenue from our Other Routes consisted of 55% from customers and 45% from the Province (4% social program fees, 33% ferry transportation fees, and 8% from payments under the Federal-Provincial subsidy agreement).

Other Routes, cont'd

Both vehicle traffic and passenger traffic increased in the three and six months ended September 30, 2009, compared to the same periods in the previous year. The increase in average tariff yield per vehicle in the second quarter was \$0.61 or 4.2% (\$1.09 or 8.0% year-to-date). The increase in average tariff yield per passenger in the second quarter was \$0.31 or 8.1% (\$0.45 or 12.5% year-to-date). The increase in traffic and the improvement in average yield resulted in \$2.6 million (\$6.1 million year-to-date) increase in tariff revenue. Average and total tariffs were significantly lower in the prior year due to redemptions of prepaid paper tickets in excess of the liability set up at March 31, 2008.

Reimbursements from the Province for social program fees were higher for the six months ended September 30, 2010 compared to the same period in the prior year as a result of higher program usage and increased fares.

Revenue from catering and on-board services and fees for reservations increased primarily as a result of higher traffic levels on routes where those services are offered.

Ferry transportation fees are lower in the quarter and year-to-date; however the annual amount is expected to equal that of the prior fiscal year.

The total Federal-Provincial subsidy has increased by the Vancouver CPI.

Expenses

Expenses for the three and six months ended September 30, 2009 and 2008 are summarized in the tables below.

Operating expenses (\$ millions)	Three months ended September 30			Six months ended September 30		
	2009	2008	Increase (Decrease)	2009	2008	Increase (Decrease)
Operations	110.1	108.8	1.3	210.5	207.6	2.9
Maintenance	14.1	16.5	(2.4)	37.8	34.8	3.0
Administration	7.0	8.4	(1.4)	14.5	17.4	(2.9)
Total operations, maintenance & administration	131.2	133.7	(2.5)	262.8	259.8	3.0
Cost of retail goods sold	10.4	9.7	0.7	17.9	16.9	1.0
Amortization	28.7	22.5	6.2	55.7	42.7	13.0
Total expenses	170.3	165.9	4.4	336.4	319.4	17.0

The \$1.3 million (\$2.9 million year-to-date) increase in operations expenses consists of:

- \$1.3 million (\$3.9 million year-to-date) increase in wages and benefits, including:
 - Approximately \$1.3 million (\$2.5 million year-to-date) in wage rate increases averaging about 3% in accordance with the existing Collective Agreement; and \$0.9 million (\$2.2 million year-to-date) increase in benefit costs reflecting a significant increase in premiums for a number of plans; partially offset by
 - \$0.9 million (\$1.5 million year-to-date) less overtime; and
- \$0.9 million (\$0.4 million year-to-date) increase consisting of a number of miscellaneous items.

These increases were partially offset by:

- \$0.9 million or 3.0% (\$1.4 million or 2.6% year-to-date) decrease in fuel expense as a result of lower prices approved by the Commissioner, partly offset by a 1.0% (1.4% year-to-date) increase in fuel consumption reflecting new vessels in service being larger than the vessels they replaced.

The \$2.4 million decrease in maintenance costs in the second quarter reflects variations in vessel refit scheduling. The \$3.0 million increase year-to-date includes \$2.0 million of unanticipated maintenance on the *Queen of Burnaby* to replace a damaged propeller in addition to schedule variations.

Administration expenses decreased \$1.4 million (\$2.9 million year-to-date) mainly as a result of reduced consulting, travel, marketing, advertising and other discretionary expenditures.

Cost of retail goods sold increased \$0.7 million (\$1.0 million year-to-date) mainly as a result of higher food and retail sales.

Amortization increased a total of \$6.2 million (\$13.0 million year-to-date) mainly as a result of additional assets coming into service, including:

- \$1.9 million (\$5.8 million year-to-date) due to the *Coastal Inspiration* and the *Coastal Celebration* entering service in June 2008 and November 2008, respectively;
- \$0.9 million (\$1.8 million year-to-date) due to the \$52 million *Queen of New Westminster* upgrade completed in April 2009;
- \$2.2 million (\$2.9 million year-to-date) due to the *Northern Expedition* commencing service in May 2009; and
- \$0.6 million (\$1.2 million year-to-date) due to the *Island Sky* commencing service in February 2009.

Interest and other (\$ millions)	Three months ended September 30			Six months ended September 30		
	2009	2008	Increase (Decrease)	2009	2008	Increase (Decrease)
Interest expense						
Bond interest	16.0	13.7	2.3	31.7	27.2	4.5
KfW loans	2.9	2.3	0.6	5.8	4.1	1.7
Short-term loans	0.1	0.3	(0.2)	0.2	0.3	(0.1)
Interest on deferred accounts	0.0	0.0	0.0	0.1	0.1	0.0
Structured Financing Facility Program	(1.3)	0.0	(1.3)	(2.6)	0.0	(2.6)
Capitalized interest	(0.4)	(3.7)	3.3	(2.1)	(7.9)	5.8
Total interest expense	17.3	12.6	4.7	33.1	23.8	9.3
(Gain) on foreign exchange	0.0	(0.1)	0.1	0.0	(0.2)	0.2
Loss (gain) on disposal of capital assets	0.0	0.1	(0.1)	0.0	(1.1)	1.1
Total interest and other	17.3	12.6	4.7	33.1	22.5	10.6

Interest expenses increased \$4.7 million (\$10.6 million year-to-date) primarily due to:

- \$2.3 million (\$4.5 million year-to-date) additional interest relating to our \$140 million bond series issued in December 2008;
- \$0.6 million (\$1.7 million year-to-date) additional interest relating to KfW loans which partially funded the purchase of the *Northern Expedition* and the *Coastal Celebration*; and
- \$3.3 million (\$5.8 million year-to-date) less interest capitalized reflecting a lower capital program;

partially offset by:

- \$1.3 million (\$2.6 million year-to-date) of interest rate support received from the Government of Canada.

During the first quarter of fiscal 2010, the Government of Canada agreed to provide an additional \$0.6 million of interest rate support through the Structured Financing Facility (SFF) Program relating to the life extension of the *Queen of New Westminster*. In October, we received approval for up to \$1.0 million of interest expense reimbursements through the SFF relating to the life extension of the *Quinsam*.

Results for the six month period in the prior year included a \$1.2 million gain from the sale of the *Queen of Esquimalt*.

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. We completed our major financing requirements in fiscal 2009. 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 September 30, 2009, our unrestricted cash and cash equivalents totalled \$55 million.

We target maintaining a strong investment-grade credit rating to allow capital market access at reasonable interest rates. Our credit ratings at September 30, 2009, were A low (DBRS) and A- (Standard & Poor's) and both rating agencies have assessed our rating outlook as positive.

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 six months ended September 30, 2009 and 2008 are summarized in the table below.

Sources and uses of cash (\$ millions)	Three months ended September 30		Six months ended September 30	
	2009	2008	2009	2008
Net earnings	64.2	53.7	60.6	62.1
Items not involving cash:				
Amortization	28.7	22.5	55.7	42.7
Other non-cash charges	0.5	(0.1)	(0.2)	(1.1)
Regulatory costs deferred	3.5	1.7	6.2	0.7
Change in operating working capital	(19.2)	(4.3)	(21.0)	(26.0)
Cash provided by operating activities	77.7	73.5	101.3	78.4
Cash (used) provided by financing activities	(24.6)	10.8	(22.8)	98.2
Cash used in investing activities	(13.5)	(85.9)	(35.9)	(286.7)
Total increase (decrease) in cash and cash equivalents	39.6	(1.6)	42.6	(110.1)

Three Months Ended September 30, 2009

In the three months ended September 30, 2009, cash provided by operating activities included an increase in non-cash working capital of \$19.2 million. This increase in working capital was primarily due to:

- \$9.3 million decrease in regulatory liabilities reflecting the return to customers through discount fare promotions of the tariff revenues collected in excess of price caps in previous quarters;
- \$4.8 million reduction in payables and accrued liabilities relating to refit and maintenance and other operating activities;
- \$5.1 million decrease in deferred revenue primarily as a result of a reduction in prepaid reservations due to the seasonality of our business;
- \$4.1 million increase in accounts receivable primarily due to:
 - \$1.8 million in social program fees receivable;
 - \$0.7 million in commercial travel cards receivable due to increased sales volume; and
 - \$0.7 million ferry transportation fees;
- \$1.9 million reduction in accrued employee costs; and
- \$0.8 million increase in total inventories.

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

- \$3.8 million decrease in prepaid expenses primarily due to the payment of annual property taxes; and
- \$3.0 million increase in interest payable on long-term debt.

Cash used by financing activities reflects the \$20.0 million repayment of short-term loans and the \$4.5 million repayment of long-term debt.

Cash used in investing activities consists mainly of \$13.5 million used to purchase capital assets. The significant capital transactions are described below in "Investing in Our Capital Assets".

Six Months Ended September 30, 2009

In the six months ended September 30, 2009, cash provided by operating activities included an increase in non-cash working capital of \$21.0 million. This increase in working capital was primarily due to:

- \$6.5 million reduction in payables and accrued liabilities relating to refit and maintenance and other operating activities;
- \$6.3 million increase in accounts receivable primarily due to:
 - \$3.5 million in social program fees receivable;
 - \$1.7 million in commercial travel cards receivable due to increased sales volume; and
 - \$1.1 million in ferry transportation fees;
- \$3.3 million reduction in accrued employee costs;
- \$2.8 million decrease in regulatory liabilities reflecting the return to customers through discount fare promotions of the tariff revenues collected in excess of price caps at March 31, 2009;
- \$2.4 million increase in total inventories primarily due to \$1.5 million increase in materials and supplies in preparation for refits and a \$0.6 million increase in fuel inventory;
- \$2.1 million decrease in deferred revenue primarily as a result of a reduction in prepaid reservations due to the seasonality of our business.

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

- \$2.4 million decrease in prepaid expenses primarily due to a \$3.4 million reduction in fuel and a \$0.3 million reduction in insurance, partially offset by an increase of \$1.4 million in property taxes.

Cash used by financing activities reflects the \$18.0 million repayment of short-term loans and the \$4.5 million repayment of long-term debt.

Cash used in investing activities consists mainly of \$35.9 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 and six months ended September 30, 2009 totalled \$12.7 million and \$29.7 million, respectively. This level of expenditure reflects the significant reduction in our capital program compared to previous years. Total capital expenditures were:

Capital expenditures (\$ millions)	September 30, 2009	
	3 Months	6 Months
Terminal and building upgrades and equipment	4.1	9.3
New vessels, vessel upgrades and modifications	1.8	8.1
Information technology	3.2	7.2
Terminal marine structures	3.6	5.1
Total capital expenditures	<u>12.7</u>	<u>29.7</u>

Terminal and Building Upgrades and Equipment

Capital expenditures for terminal and building upgrades and equipment in the three and six months ending September 30, 2009 included the following:

Terminal and building upgrades and equipment (\$ millions)	September 30, 2009	
	3 Months	6 Months
Terminal security upgrades	1.2	3.6
Departure Bay terminal	1.7	3.5
Vehicles, machinery & equipment	0.9	1.5
Other terminal projects	0.3	0.7
	<u>4.1</u>	<u>9.3</u>

At nine terminals, mainly serving our Major and Northern Routes, we continued 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. Transport Canada, through the Marine Security Contribution Program, allocated approximately \$9.3 million of federal funding to help offset our costs of perimeter security, access control measures and training. The program requires us to apply for reimbursement of 75% of the eligible costs of security enhancements on approved projects as capital expenditures are incurred. We have submitted claims for reimbursement of approximately \$2.4 million of which, to date, we have received \$0.6 million.

At Departure Bay terminal, a new waiting room is under construction. Also, waste management facilities have been consolidated and employee parking has been expanded and paved. This is a continuation of the master plan for improvements at this terminal that began last fiscal year and is expected to complete in fiscal 2011.

The costs incurred to date for vehicles, machinery, and equipment include the purchase of six hostling units this quarter to support our new drop-trailer service. During this fiscal year, we expect to purchase a total of 20 units. These units will be used to move commercial trailers to and from our holding compounds. During the period, we also continued with our planned replacement of select vehicles and baggage carts.

New Vessels, Vessel Upgrades and Modifications

Capital expenditures for new vessels, vessel upgrades and vessel modifications in the three and six months ending September 30, 2009 included the following:

New vessels, vessel upgrades and modifications (\$ millions)	September 30, 2009	
	3 Months	6 Months
New northern vessel, the <i>Northern Expedition</i>	0.1	4.4
Voyage Data Recorders and navigational aids and upgrade of vessel connectivity	0.4	0.9
Sewage treatment upgrade program	0.3	0.9
Upgrade of emergency lighting system on the <i>Northern Adventure</i>	0.0	0.4
Vessel security upgrades	0.1	0.3
Other projects	0.9	1.2
	<u>1.8</u>	<u>8.1</u>

On May 18, 2009, the new *Northern Expedition* made its inaugural voyage on our northern route through the Inside Passage from Port Hardy to Prince Rupert. This 150-metre vessel, which replaced the 43-year-old *Queen of Prince Rupert*, has 55 staterooms and has a capacity of up to 130 vehicles and 600 passengers. A \$133 million contract with Flensburger Schiffbau-Gesellschaft to build this new vessel was signed in July 2006 and completed on schedule and on budget. The import duties and taxes on this contract total approximately \$44 million. We are seeking a remission of the import duties and related GST of approximately \$37 million, but are uncertain as to the outcome of our application.

The two-year program to install Voyage Data Recorders and navigational aids and upgrade vessel connectivity is substantially complete. The remaining few vessels will be completed as they undergo their planned refits.

Implementation of a multi-year sewage and waste water treatment program to upgrade 20 vessels and eight terminals for treatment of sewage generated by the vessels is underway. The program involves major modifications and upgrades to ensure that all vessels comply with new Canada Shipping Act sewage regulations, which will apply effective July 1, 2012. Wherever possible, the vessels will convey sewage to a terminal through pump-ashore infrastructure. In all other cases, the vessels will be fitted with compliant Marine Sanitation Devices. We are working with local governments to seek their approval to pump effluent into their systems at our cost. Modification of the first vessel, the *Skeena Queen*, is complete and we have received approval from the local government to connect the Swartz Bay terminal to their existing infrastructure. As part of the Federal government's Infrastructure Stimulus Fund program, we estimate we will receive \$7.5 million to assist with sewage pump-ashore projects and other major terminal projects.

Information Technology

Capital expenditures for information technology in the three and six months ending September 30, 2009 included the following:

Information technology (\$ millions)	September 30, 2009	
	3 Months	6 Months
Enterprise resource planning upgrade	1.1	3.6
Network for the operations centre	0.4	1.2
Automated ticketing software	0.2	0.4
Other projects	1.5	2.0
	<u>3.2</u>	<u>7.2</u>

The most significant information technology project has been our enterprise resource planning (ERP) upgrade which includes financial and related operating systems. The first and largest phase of this project was implemented on August 30, 2009. The second phase, which will include enhancements to enable reporting under International Financial Reporting Standards (IFRS), is expected to be completed this fiscal year. This upgrade will provide future opportunities for operational improvements through its advanced functionality.

Also completed in the six months ending September 30, 2009 was the first phase of the implementation of our operations and security centre. We installed video terminals, wall displays, cameras, and computer hardware and software that will allow for real-time situational awareness and monitoring of fleet operations.

Terminal Marine Structures

Capital expenditures for terminal marine structures in the three and six months ending September 30, 2009 included the following:

Terminal marine structures (\$ millions)		September 30, 2009	
Terminal	Description	3 Months	6 Months
Fulford Harbour	Replacement of two dolphins and maintenance walkway	1.0	1.5
Tsawwassen	Replacement of six dolphins and associated catwalks	0.2	0.8
Langdale	Replacement of wingwall	0.7	0.7
Prince Rupert	Addition of a tie up dolphin for the <i>Northern Expedition</i>	0.6	0.6
Tsawwassen	Restoration of the concrete transfer deck	0.4	0.4
Skidegate	New pontoon, ramp, ramp abutment and two dolphins	0.0	0.3
Various	Other projects	0.7	0.8
		<u>3.6</u>	<u>5.1</u>

Preparations at Skidegate to accommodate the new *Northern Expedition* were completed in the first quarter of fiscal 2010. At Fulford Harbour and Prince Rupert terminals, the dolphins and the maintenance walkway are substantially complete and now in use.

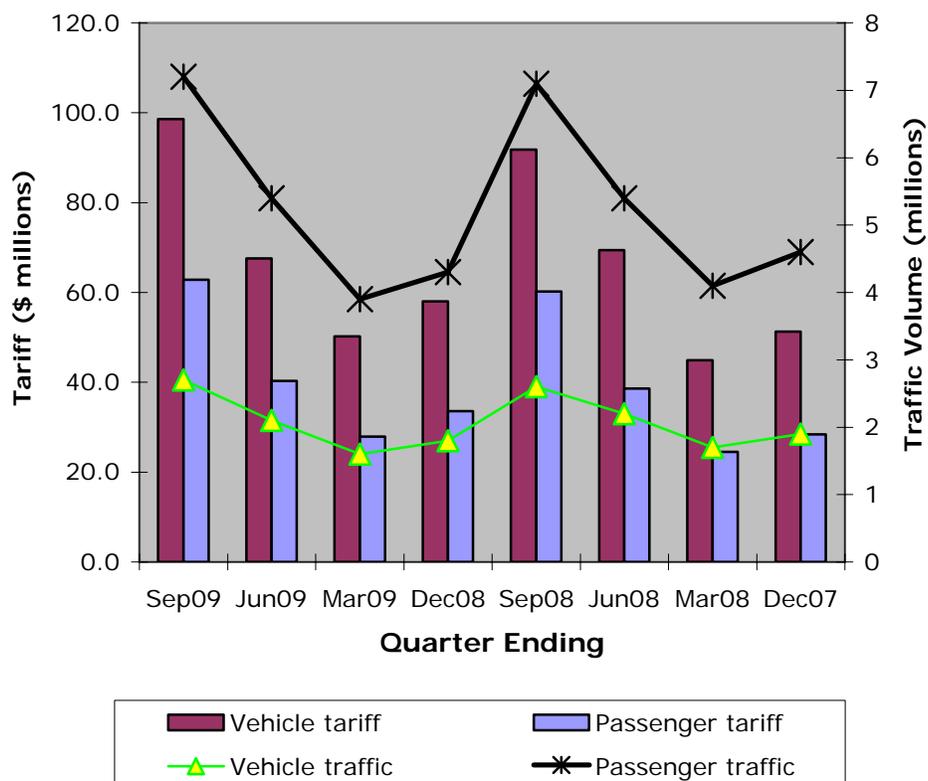
SUMMARY OF QUARTERLY RESULTS

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

(\$ millions)	Quarter Ended (unaudited)							
	Sep 09	Jun 09	Mar 09	Dec 08	Sep 08	Jun 08	Mar 08	Dec 07
Total revenue	251.8	178.3	128.5	149.4	232.1	171.9	124.2	136.5
Earnings (loss) from operations	81.5	12.2	(25.1)	(1.7)	66.2	18.4	(20.0)	(0.4)
Net earnings (loss) and comprehensive income (loss)	64.2	(3.6)	(38.4)	(14.6)	53.7	8.4	(30.5)	(7.8)

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.



FINANCIAL RISKS AND FINANCIAL INSTRUMENTS

Exposure to credit risk, liquidity risk and market risk arises in the normal course of our business. We manage market risk arising from the volatility in foreign currency, interest rate, and fuel price exposures in part through the use of derivative financial instruments including forward contracts, swaps and options. We do not utilize derivative financial instruments for trading or speculative purposes.

A discussion of financial risks can be found on pages 38 through 40 of our fiscal 2009 Management's Discussion & Analysis. Our risk profile is substantially unchanged during the six months ended September 30, 2009.

BUSINESS 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 on pages 41 through 44 of our fiscal 2009 Management's Discussion & Analysis. Our risk profile is substantially unchanged during the six months ended September 30, 2009.

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.

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, 2009 and September 30, 2009 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 44 through 46 of our fiscal 2009 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 six months ended September 30, 2009, or expect to use in the future.

Adoption of New Accounting Standards

Effective April 1, 2009, we adopted the following CICA Handbook Sections:

- 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. Other than reclassifications and additional disclosure in Note 5, the adoption of this section has had no impact on our consolidated financial statements.

- 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 has been 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 for entities subject to rate regulation. The adoption of these amendments has had no 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.
- Emerging Issues Committee (EIC) Abstract 173 *Credit Risk and Fair Value of Financial Assets and Financial Liabilities* confirms that our own credit risk and the credit risk of our counterparties should be taken into consideration in determining the fair value of financial assets and liabilities. The adoption of this guidance has had no significant effect on our consolidated financial statements.

Future Accounting Changes

The following is a discussion of accounting changes that will be effective for us in future periods:

- 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. 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 are monitoring ongoing standards development as issued by the International Accounting Standards Board and the CICA Accounting Standards Board as well as regulatory developments as issued by the Canadian Securities Administrators, which may affect the timing, nature or disclosure relating to our adoption of IFRS.

The transition to IFRS may materially affect our reported financial position and results of operations. As our analysis is still underway and accounting policy choices, as well as exemptions under *IFRS 1 First-Time Adoption of IFRS* (IFRS 1), have not yet been selected, we are unable to quantify the impact of IFRS on the future financial position and results of operations.

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.

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. A full review to assess IFRS conversion impacts on our information systems is also in progress. Our financial information systems have just undergone an upgrade and we are evaluating the alternatives that are available as part of this upgrade.

The following table includes elements of our IFRS transition plan and an assessment of progress towards achieving the key milestones. We are working through a detailed IFRS transition plan and certain project activities and milestones could change. Further, changes in regulation or timing of standard development throughout the project could result in changes to the transition plan. The following tables provide further insight into our IFRS project.

<p>Financial statement preparation</p> <p><i>Key activities</i></p> <ul style="list-style-type: none"> • Identify differences in Canadian GAAP / IFRS accounting policies • Select ongoing IFRS policies • Select IFRS 1 elections • Develop financial statement format • Quantify effects of change at April 1, 2010 (for fiscal 2011 comparative financial statements) <p><i>Status</i></p> <ul style="list-style-type: none"> • Scoping and diagnostic phase completed in fiscal 2009, with high-level review of the major differences between Canadian GAAP and IFRS • Highest areas of impact identified and review of IFRS prioritized • In-depth analysis of issues and accounting policy choices is currently underway
<p>Training, Education & Communication</p> <p><i>Key activities</i></p> <ul style="list-style-type: none"> • Determine required level of IFRS expertise within all areas of the company • Ensure appropriate training of key members within Finance • Provide appropriate education and communication to affected departments • Keep key stakeholders informed <p><i>Status</i></p> <ul style="list-style-type: none"> • Core IFRS project team members completed initial training in fiscal 2009 and are currently enrolled in the "IFRS Award Program, Certificate Level" through the CICA • Interdepartmental workshops provided on specific topics, including property, plant and equipment; IFRS1; and the IFRS Framework • Ongoing identification of training requirements of other departments for inclusion in future training plans • Ongoing communications with key stakeholders, including direct communication with the Commissioner, our Agent Bank, rating agencies, and our Board of Directors, and with investors indirectly through our website
<p>Information technology infrastructure</p> <p><i>Key activities</i></p> <ul style="list-style-type: none"> • Confirm system upgrades required for IFRS reporting • Review/revise data gathering processes • Review/revise budgeting and forecasting processes <p><i>Status</i></p> <ul style="list-style-type: none"> • IFRS project team coordinating efforts with ERP systems upgrade team (first phase of ERP upgrade complete) • Detailed business requirements to accommodate IFRS reporting underway • IFRS system implementation planned to be complete by March 31, 2010

Control environment
<p>Key activities</p> <ul style="list-style-type: none"> • Accounting policy determination, documentation and implementation • MD&A ongoing communications
<p>Status</p> <ul style="list-style-type: none"> • Analysis of control issues underway as part of the detailed implementation plan
Business policy assessment
<p>Key activities</p> <ul style="list-style-type: none"> • Financial covenants assessment • Compensation arrangements assessment • Customer and supplier contract evaluation
<p>Status</p> <ul style="list-style-type: none"> • All relevant GAAP-dependent covenants and contracts have been identified • Analysis to determine affects of IFRS on existing covenants and contracts underway

A summary of progress in the review of areas originally identified to have the highest potential to impact us is as follows:

- Rate-regulated operations: On July 23, 2009, the International Accounting Standards Board (IASB) published Exposure Draft "Rate-regulated Activities" to define regulatory assets and regulatory liabilities, set out criteria for their recognition, specify how they should be measured and require disclosures about their financial effects. We have reviewed this exposure draft and are in the process of responding to the IASB requesting clarification of scope as defined in the exposure draft.
- Property, plant and equipment: The capitalization of inspections and major overhauls of our vessels is the largest change affecting us. We are currently working to:
 - ◊ define and identify inspection and major overhaul for each vessel;
 - ◊ quantify those inspections and major overhauls for reclassification of property, plant and equipment at transition date; and
 - ◊ determine the best solution for tracking and reporting of these costs.
As this review is in progress, the effect on our consolidated financial statements of the adoption of this guidance cannot be quantified at this time.
- Intangible assets: There is substantially no change in IFRS from Section 3064, *Goodwill and Intangible Assets*, which we adopted April 1, 2009. The adoption of this guidance is not expected to have any significant effect on our consolidated financial statements.
- Asset impairment: We are currently defining indications of impairment and determining a process to track any asset impairment and potential subsequent reversals. The adoption of this guidance is not expected to have any significant effect on our consolidated financial statements.
- IFRS 1 *First-Time Adoption of IFRS*: The elections and exemptions under IFRS 1 are being reviewed, including proposed amendments relating to rate-regulated activities. Some decisions have been made while others are in progress. As this process is not complete, the effect on our consolidated financial statements of the adoption of IFRS 1 cannot be quantified at this time.

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, 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.