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

For the three and nine months ended December 31, 2010
Dated February 1, 2011

BCFerries

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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 February 1, 2011. 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, 2010 and 2009, and our fiscal 2010 audited consolidated financial statements and related notes together with our fiscal 2010 Management's Discussion & Analysis. These documents are available on our Investor Relations 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 36 vessels and 47 terminals. We also manage ferry transportation service on other remote routes through contracts with independent operators.

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 December 31, 2010 (the third quarter of fiscal 2011), we provided 46,000 sailings, carrying over 4.4 million passengers and 1.8 million vehicles.

Significant events during or subsequent to our third quarter of fiscal 2011:

- On October 1, 2010, it was announced that our request for duty remission, amounting to $119.4 million including related GST, on four vessels built in Germany had been granted by the Government of Canada. One of these vessels, the *Northern Expedition*, operates on our Northern Routes which are supported by ferry transportation fees paid by the Province pursuant to the Coastal Ferry Services Contract. An agreement with the Province stipulated that these fees would be reduced if we were successful in obtaining duty remission on the *Northern Expedition*. The Province has agreed to forego this fee reduction, amounting to approximately $5.3 million for the balance of performance term two, which ends March 31, 2012.

  The $119.4 million in duty remission plus the contribution from the Province, has been utilized in an across the board fare reduction of approximately 2% effective October 18, 2010. The duty remission will also reduce future price caps otherwise determined by the British Columbia Ferries Commissioner (the Commissioner), commencing with performance term three. We will also allocate $20 million of this amount to upgrade key assets in the ship repair and maintenance business in British Columbia.

  Our submission to the Commissioner, filed September 30, 2010, has been revised to reflect the impact of duty remission on price caps for performance term three. Despite the positive effect of duty remission, we expect the price cap setting process will result in significant price cap increases for all route groups over performance term three, assuming no changes in core service levels and related ferry transportation fees.

- On October 1, 2010, certain sections of *Bill 20 – Miscellaneous Statutes Amendment Act (No.3), 2010* (Bill 20), enacted June 24, 2010, were brought into force. Significant changes arising from Bill 20 include the requirement that the B.C. Ferry Authority and British Columbia Ferry Services Inc. boards no longer have directors in common and we are now subject to the *Freedom of Information and Protection of Privacy Act*.
- On November 1, 2010, we advanced the developer of our new corporate head office in downtown Victoria $24.2 million for a term of 15 years, secured by a second mortgage on the property. (See Investing in Our Capital Assets – Assets Acquired under Capital Lease for more detail)
- On November 1, 2010, our previous corporate office building was sold for approximately $11 million, resulting in a gain on sale of $9.3 million.
- On December 1, 2010, we provided our transition plan to employees regarding arbitrator Mr. Vince Ready's award that determined that certain senior shipboard positions should be part of the management structure and therefore excluded from the bargaining unit. We plan to complete the majority of the implementation of this award for the deck, catering and senior chief engineers by December 31, 2012.
- On December 1, 2010, the fuel rebate of 2% of tariffs on average was removed from all of our Major and Other routes due to the increasing cost of fuel. No rebates were in place on our Northern Routes.
- On December 1, 2010, Standard & Poor's affirmed our credit rating at A+ with a stable outlook on strong financial management.
- On December 8, 2010, we responded to stakeholder comments regarding our submission on our drop trailer service. The Commissioner is now in the process of considering all the materials received, after which determinations will be made and any decisions required will be issued. The ruling is expected the week of February 7, 2011.
- On December 14, 2010, the *Queen of Cumberland* returned to service after completion of a $6 million combined refit and asset improvement project. The vessel underwent an extensive mechanical refit and drydocking, a passenger accommodation upgrade, installation of new car deck deluge piping, and upgrades to the sewage system. (See Investing in Our Capital Assets – Capital Expenditures for more detail)
- On December 17, 2010, the *Queen of Nanaimo* returned to service after completion of a $4 million asset betterment project that included steel renewal throughout the vessel and a new exhaust system. (See Investing in Our Capital Assets – Capital Expenditures for more detail)
- On January 7, 2011 the Commissioner released his determination that our rate of return on equity to be used in setting preliminary price caps for the third performance term will be 12.73%.
- On February 1, 2011, the Commissioner released his conditional approval of our customer complaints process, fulfilling a new requirement of the *Coastal Ferry Act*, as amended by Bill 20.

FINANCIAL AND OPERATIONAL OVERVIEW

This section provides an overview of our financial and operational performance for the three and nine months ended December 31, 2010 and 2009.

($ millions)	Three months ended December 31			Nine months ended December 31		
	2010	**2009**	**Variance**	**2010**	**2009**	**Variance**
Total revenue	162.3	159.9	2.4	598.6	590.0	8.6
Expenses	(165.6)	(161.8)	(3.8)	(510.5)	(498.2)	(12.3)
(Loss) earnings from operations	(3.3)	(1.9)	(1.4)	88.1	91.8	(3.7)
Interest and other	(9.1)	(18.5)	9.4	(45.3)	(51.6)	6.3
Net (loss) earnings and comprehensive income	(12.4)	(20.4)	8.0	42.8	40.2	2.6

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.

In the third quarter of fiscal 2011, we experienced a decline of 0.9% in vehicle traffic and an increase of 0.4% in passenger traffic as compared to the same period in the prior year. Drop-trailer traffic increased, while bus and other commercial vehicle traffic decreased. On a year-to-date basis, vehicle traffic was 1.5% lower and passenger traffic was 0.5% lower than the prior year.

With lower tourism and reduced discretionary travel resulting from the current economic conditions, we expect vehicle and passenger traffic this fiscal year to be slightly lower than that of the prior year. We expect that this may result in a small operational loss for fiscal 2011, prior to the one-time gain on the sale of our former corporate head office building.

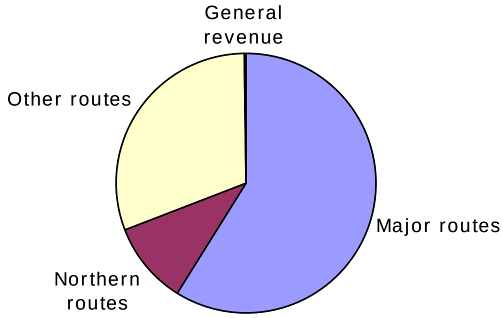
We do not anticipate that economic conditions will improve substantially in the near term and are continuing our program of cost containment and deferrals, while maintaining safe, reliable service.

We are currently forecasting a net loss estimated to be in the range of $20 million for fiscal 2012, largely driven by significantly lower traffic levels than those included in setting our performance term two price caps. Despite the loss, we have no plans to reduce our refit and maintenance programs, training and safety programs or capital programs. Although lower traffic levels are the major driver, other contributing factors to this loss are such items as the harmonized sales tax, Transport Canada requirements and Freedom of Information overhead expenses and other costs associated with Bill 20. We expect to return to profitability in fiscal 2013, the first year of performance term three.

We will not be applying to the Commissioner for an interim price cap increase as a result of these lower traffic levels. Our strong balance sheet and cash position (aided significantly by the $119.4 million remission of federal import taxes and related GST on new vessels) will enable us to maintain our current level of operations while continuing to invest in our future.

Revenue

Total revenues for the three months and the nine months ended December 31, 2010 increased 1.5% over the same periods in the previous year as shown in the table below.



In the nine months ended December 31, 2010, the greatest portion of our revenues, 59%, was earned on our three Major Routes connecting Vancouver Island to Vancouver and the Lower Mainland. The revenue from the Northern Routes contributed 10% and Other Routes contributed 30%.

Revenue ($ millions)	**Three months ended December 31**			**Nine months ended December 31**		
	2010	**2009**	**Increase (Decrease)**	**2010**	**2009**	**Increase (Decrease)**
Direct Route Revenue						
Vehicle traffic (volume)	*1,812,219*	*1,828,075*	*(15,856)*	*6,563,859*	*6,666,534*	*(102,675)*
Vehicle tariff	62.3	61.5	0.8	230.1	227.8	2.3
Passenger traffic (volume)	*4,463,480*	*4,443,746*	*19,734*	*17,001,284*	*17,079,855*	*(78,571)*
Passenger tariff	36.8	35.3	1.5	142.9	138.4	4.5
Social program fees	5.7	5.5	0.2	19.0	17.2	1.8
Catering & on-board	16.8	16.6	0.2	64.1	64.3	(0.2)
Other revenue	4.7	5.1	(0.4)	20.0	18.6	1.4
Total Direct Route Revenue	126.3	124.0	2.3	476.1	466.3	9.8
Indirect Route Revenue						
Ferry transportation fees	28.3	28.2	0.1	99.9	100.3	(0.4)
Federal-Provincial subsidy	6.7	6.7	-	20.2	20.2	-
Total Route Revenue	161.3	158.9	2.4	596.2	586.8	9.4
Other general revenue	1.0	1.0	-	2.4	3.2	(0.8)
Total Revenue	162.3	159.9	2.4	598.6	590.0	8.6

Our largest revenue source is vehicle and passenger tariffs. The Commissioner authorized a price cap increase on the Major Routes of 2.7% plus 0.49 times the Consumer Price Index (CPI) (British Columbia) and 5.7% plus 0.73 times the CPI (British Columbia) on all other routes effective on each of April 1, 2010 and April 1, 2011. On April 1, 2010, the price caps increased by 2.68% on the Major Routes and 5.68% on all other routes, which incorporated a change in the CPI (British Columbia) of -0.03%. In response, we implemented tariff increases up to the new level authorized. We anticipate price cap increases on April 1, 2011 of approximately 3.38% on our Major Routes and 6.71% on our other routes, incorporating a 2010 CPI increase of 1.39%.

From time to time, we utilize promotional fares 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 allowed increase in any one period.

Throughout the eight months ended November 30, 2010, fuel rebates of 2% of tariffs on average were in place on our Major Routes. The fuel rebate on many of our Other Routes was reduced on August 17, 2010 from 5% to 2% on average. On December 1, 2010, the fuel rebate was removed from all of our Major and Other Routes due to the increasing cost of fuel. No fuel surcharges or rebates were in place on our Northern Routes.

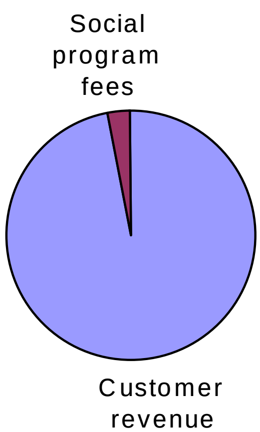
Year to year changes for the three and nine months ended December 31, 2010 for our Major, Northern and Other Routes are discussed separately below:

Major Routes

Direct Route Revenue ($ thousands)	Three months ended December 31			Nine months ended December 31		
	2010	**2009**	**Increase (Decrease)**	**2010**	**2009**	**Increase (Decrease)**
Vehicle traffic (volume)	*814,247*	*808,563*	*5,684*	*3,027,643*	*3,062,400*	*(34,757)*
Vehicle tariff	47,576	46,456	1,120	169,827	168,938	889
Passenger traffic (volume)	*2,288,150*	*2,238,134*	*50,016*	*8,891,959*	*8,836,913*	*55,046*
Passenger tariff	27,838	26,519	1,319	102,768	99,372	3,396
Social program fees	2,858	2,690	168	9,434	8,440	994
Catering & on-board	14,175	13,779	396	52,217	51,831	386
Reservation fees	2,451	2,759	(308)	10,244	10,329	(85)
Parking	838	963	(125)	2,971	2,860	111
Assured loading	554	593	(39)	3,327	1,999	1,328
Other revenue	474	473	1	1,546	1,670	(124)
Total Direct Route Revenue	96,764	94,232	2,532	352,334	345,439	6,895
Indirect Route Revenue						
Ferry transportation fees	-	-	-	-	-	-
Federal-Provincial subsidy	-	-	-	-	-	-
Total Route Revenue	96,764	94,232	2,532	352,334	345,439	6,895

Our Major Routes consist of three regulated routes connecting Greater Vancouver with mid and southern Vancouver Island. Vehicle and passenger traffic improved in the third quarter, compared to the same period in the previous year. Vehicle traffic increased 0.7% in the third quarter following two quarters of traffic levels lower than the previous year while passenger traffic increased 2.2% in the third quarter (0.6% year-to-date). Overall annual traffic levels on these routes are expected to be similar to the prior fiscal year.

In the third quarter, average tariff revenue per vehicle increased $0.97 or 1.7% ($0.92 or 1.7% year-to-date) while average tariff revenue per passenger increased $0.32 or 2.7% ($0.31 or 2.8% year-to-date).



In the nine months ended December 31, 2010, revenue from our Major Routes consisted of 97% from customers and 3% from social program fees.

On December 1, 2010 fuel rebates of 2% of tariffs on average were removed due to the increasing cost of fuel.

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 Ministry of Health Travel Assistance Program. Social program fees increased as a result of higher fares and higher usage in most programs.

All vessels that provide service on our Major Routes have a gift shop and options for food service. In the third quarter, food and gift shop sales increased 2.9%, mainly as a result of a higher number of passengers.

Reservation fees and parking revenue decreased in the quarter. In the nine months ended December 31, 2010, the increase in parking revenue reflects greater use of parking facilities at our Swartz Bay terminal in the first and second quarters of fiscal 2011.

The year-to-date increase in assured loading revenue reflects a gain relating to expired tickets.

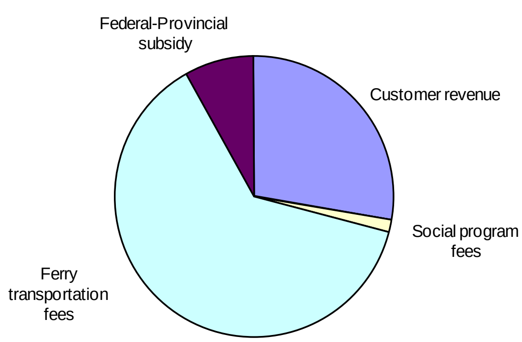
Other revenue for the third quarter remains at the same level as the third quarter of the previous year. Year-to-date, other revenue is lower mainly as a result of lower retail commissions, partially offset by an increase in hostling[1] fees from our drop-trailer service for commercial customers.

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

Northern Routes

Direct Route Revenue ($ thousands)	Three months ended December 31			Nine months ended December 31		
	2010	**2009**	**Increase (Decrease)**	**2010**	**2009**	**Increase (Decrease)**
Vehicle traffic (volume)	*4,051*	*4,326*	*(275)*	*25,946*	*27,678*	*(1,732)*
Vehicle tariff	845	887	(42)	7,210	7,281	(71)
Passenger traffic (volume)	*10,315*	*10,171*	*144*	*76,685*	*79,142*	*(2,457)*
Passenger tariff	500	505	(5)	6,902	6,652	250
Social program fees	175	190	(15)	824	732	92
Catering & on-board	166	168	(2)	2,061	2,236	(175)
Stateroom rental	159	177	(18)	859	909	(50)
Hostling & other	51	49	2	181	198	(17)
Total Direct Route Revenue	1,896	1,976	(80)	18,037	18,008	29
Indirect Route Revenue						
Ferry transportation fees	8,386	8,362	24	39,070	39,444	(374)
Federal-Provincial subsidy	1,665	1,665	-	4,995	4,995	-
Total Route Revenue	11,947	12,003	(56)	62,102	62,447	(345)

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, 2010, revenue from our Northern Routes consisted of 28% from customers and 72% from the Province (1% social program fees, 63% ferry transportation fees, and 8% from payments under the Federal-Provincial subsidy agreement).

Vehicle traffic decreased 6.4% in the three months ended December 31, 2010 (6.3% year-to-date), compared to the same periods in the previous year. Passenger traffic increased 1.4% in the third quarter reducing the year-to-date decrease to 3.1% compared to the same periods in the previous year. We anticipate overall annual traffic levels to be approximately 3% lower than the prior fiscal year.

In the third quarter, the average tariff revenue per vehicle increased $3.55 or 1.7% ($14.82 or 5.6% year-to-date) mainly as a result of higher fares for commercial vehicles.

The average tariff revenue per passenger in the third quarter decreased $1.18 or 2.4% ($5.95 or 7.1% increase year-to-date). The reduction in vehicle traffic was partially offset by the overall increase in average fares and the increase in passenger traffic, resulting in a small total tariff revenue decrease for the third quarter ($0.2 million increase year-to-date).

Reimbursements from the Province for social program fees were lower in the quarter as a result of lower usage and lower average passenger fares. Year-to-date, social program fees increased as a result of higher average fares, partially offset by lower usage in most programs.

Revenue from catering and on-board services was lower in the third quarter as a result of lower average spending per passenger while year-to-date it has decreased mainly as a result of lower traffic levels.

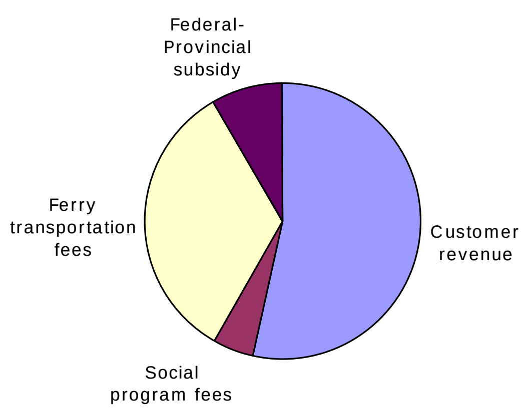
We receive ferry transportation fees for these routes under the Coastal Ferry Services Contract. In the quarter, these fees are higher reflecting a higher number of round trips compared to the same period of the prior year. The year-to-date decrease arises from contractual adjustments which reflect the anticipated declining net book value of the vessels used on these routes, partially offset by a higher number of round trips compared to the same period of the prior year. The total annual transportation fees are expected to be $0.5 million lower than the prior fiscal year.

The Federal-Provincial subsidy this fiscal year will be equal to the prior year reflecting no change in the annual CPI (Vancouver).

Other Routes

Direct Route Revenue ($ thousands)	**Three months ended December 31**			**Nine months ended December 31**		
	2010	**2009**	**Increase (Decrease)**	**2010**	**2009**	**Increase (Decrease)**
Vehicle traffic (volume)	*993,921*	*1,015,186*	*(21,265)*	*3,510,270*	*3,576,456*	*(66,186)*
Vehicle tariff	13,939	14,111	(172)	53,101	51,572	1,529
Passenger traffic (volume)	*2,165,015*	*2,195,441*	*(30,426)*	*8,032,640*	*8,163,800*	*(131,160)*
Passenger tariff	8,388	8,312	76	33,199	32,356	843
Social program fees	2,685	2,547	138	8,696	7,996	700
Catering & on-board	2,326	2,521	(195)	8,946	9,358	(412)
Reservation fees	217	198	19	1,305	1,233	72
Parking & other	124	83	41	400	334	66
Total Direct Route Revenue	27,679	27,772	(93)	105,647	102,849	2,798
Indirect Route Revenue						
Ferry transportation fees	19,851	19,826	25	60,869	60,851	18
Federal-Provincial subsidy	5,066	5,066	-	15,198	15,198	-
Total Route Revenue	52,596	52,664	(68)	181,714	178,898	2,816

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, 2010, revenue from our Other Routes consisted of 53% from customers and 47% from the Province (5% social program fees, 34% ferry transportation fees, and 8% from payments under the Federal-Provincial subsidy agreement).

Other Routes, cont'd

Both vehicle traffic and passenger traffic decreased in the three and nine months ended December 31, 2010, compared to the same periods in the previous year. We anticipate annual passenger and vehicle traffic levels to be marginally lower than the prior fiscal year.

In the third quarter, the average tariff revenue per vehicle increased $0.12 or 0.9% ($0.71 or 4.9% year-to-date) while the average tariff revenue per passenger increased $0.08 or 2.1% ($0.17 or 4.3% year-to-date). The reduction in traffic was partially offset by the increase in average fares, resulting in lower tariff revenue in the quarter of $0.1 million ($2.4 million higher year-to-date).

On December 1, 2010 fuel rebates of 2% of tariffs on average were removed due to the increasing cost of fuel.

Reimbursements from the Province for social program fees increased in both the quarter and year-to-date as a result of higher usage in some programs and higher fares.

Revenue from catering and on-board services decreased in the three and nine months ended December 31, 2010 compared to the same periods in the previous year as a result of lower average spending per passenger and lower traffic on the routes where those services are offered. Year-to-date revenue was also affected by the closure of the cafeteria and retail areas on the *Queen of Burnaby* for approximately one month in the first quarter as some asbestos abatement work was being done in these areas.

Fees for reservations increased in the quarter and year-to-date primarily as a result of a new offering to customers on our route connecting Comox and Powell River.

Ferry transportation fees are slightly higher in the quarter and year-to-date. However, total annual transportation fees are expected to equal that of the prior fiscal year.

The Federal-Provincial subsidy this fiscal year will be equal to the prior year reflecting no change in the annual CPI (Vancouver).

Expenses
Expenses for the three and nine months ended December 31, 2010 and 2009 are summarized in the tables below:

Operating expenses	**Three months ended December 31**			**Nine months ended December 31**		
($ millions)	**2010**	**2009**	**Increase (Decrease)**	**2010**	**2009**	**Increase (Decrease)**
Operations	96.7	95.3	1.4	315.2	305.8	9.4
Maintenance	26.8	22.8	4.0	63.3	60.6	2.7
Administration	7.5	7.8	(0.3)	22.3	22.3	-
Total operations, maintenance & administration	131.0	125.9	5.1	400.8	388.7	12.1
Cost of retail goods sold	6.5	6.4	0.1	24.5	24.3	0.2
Amortization	28.1	29.5	(1.4)	85.2	85.2	-
Total expenses	165.6	161.8	3.8	510.5	498.2	12.3

The $1.4 million ($9.4 million year-to-date) increase in operations expenses consists of:

- $1.3 million ($4.3 million year-to-date) increase in wages and benefits, mainly as a result of wage rate increases averaging about 3% in accordance with the existing Collective Agreement;
- $1.3 million or 5.9% ($2.3 million or 3.2% year-to-date) increase in fuel expense as a result of higher approved prices and a 0.1% (0.3% year-to-date) increase in fuel consumption;
- $0.2 million ($0.9 million year-to-date) increase relating to the new Vacations Centre;
- $1.4 million decrease ($1.9 million increase year-to-date) consisting of a number of miscellaneous items.

The $4.0 million ($2.7 million year-to-date) increase in maintenance expense reflects variations in the vessel refit schedule and general increases in terminal maintenance costs.

The $0.3 million decrease in administration expenses in the quarter is mainly a result of lower wage and benefit expense, partially offset by higher annual information technology licence fees and support costs. This reflects the continuation of our cost containment measures previously implemented in response to declines in traffic.

Amortization decreased $1.4 million in the quarter mainly due to a reduction in capital costs of the Coastal class vessels and the *Northern Expedition* as a result of a $119.4 million refund of import taxes and related GST on these foreign-built vessels. Year-to-date, the $3.1 million decrease in amortization resulting from the refund of import taxes and related GST is offset by additional assets coming into service, including the *Northern Expedition* which commenced service in May 2009.

Interest and other ($ millions)	**Three months ended December 31** 2010	2009	Increase (Decrease)	**Nine months ended December 31** 2010	2009	Increase (Decrease)
Interest expense						
Bond interest	16.0	16.0	-	47.7	47.7	-
KfW bank group (KfW) loans	2.6	2.8	(0.2)	8.0	8.6	(0.6)
Interest on capital leases	0.6	-	0.6	0.6	-	0.6
Short-term loans	-	-	-	0.1	0.3	(0.2)
Interest on regulatory accounts	-	0.1	(0.1)	0.3	0.2	0.1
Structured Financing Facility Program	(0.1)	(1.3)	1.2	(0.3)	(3.9)	3.6
Capitalized interest	(0.8)	(0.4)	(0.4)	(2.0)	(2.5)	0.5
Total interest expense	18.3	17.2	1.1	54.4	50.4	4.0
(Gain) on foreign exchange	(0.1)	-	(0.1)	(0.2)	(0.1)	(0.1)
(Gain) loss on disposal of capital assets	(9.1)	1.3	(10.4)	(8.9)	1.3	(10.2)
Total interest and other	9.1	18.5	(9.4)	45.3	51.6	(6.3)

Interest expenses in the third quarter increased $1.1 million primarily due to:

- $1.2 million less interest rate support received than in the prior year through the Government of Canada's Structured Financing Facility (SFF) program; and
- $0.6 million interest on our new corporate office capital lease.

These increases were partially offset by $0.4 million more interest capitalized and $0.2 million less interest on KfW loans as a result of principal repayments of $4.5 million in July 2010.

Interest expenses year-to-date increased $4.0 million primarily due to:

- $3.6 million higher SFF interest rate support received in the prior year;
- $0.6 million interest on our new corporate office capital lease; and
- $0.5 million less interest capitalized.

These increases were partially offset by $0.6 million less interest on KfW loans as a result of principal repayments of $4.5 million in July 2009 and 2010.

On November 1, 2010, our previous corporate office building was sold for approximately $11 million, resulting in a gain on sale of $9.3 million.

Structured Financing Facility

On April 13, 2010, we received approval for up to $1.8 million of additional interest rate support payments through the SFF program relating to the life extension of the *Quadra Queen II,* which is expected to be completed by the end of this fiscal year.

In October 2010, the Government of Canada provided $1.0 million of interest rate support payments relating to the life extension of the *Quinsam.* Of the $1.0 million, $0.1 million was recorded as a reduction of capitalized interest and $0.3 million as a reduction of interest expense year-to-date. The balance will reduce future interest costs.

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. On October 1, 2010, it was announced that our request for duty remission on four vessels built in Germany, totalling $119.4 million (including related GST), had been granted. These funds were received from the Government of Canada in December 2010.

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, 2010, our unrestricted cash and cash equivalents totalled $96 million and we held short-term investments totalling $59 million. Our credit facility was undrawn.

We target maintaining a strong investment-grade credit rating to allow capital market access at reasonable interest rates. Our credit ratings at December 31, 2010, were A (DBRS) with a stable trend and A+ (Standard & Poor's) with a stable outlook.

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 payments on our long-term debt.

Sources and uses of cash and cash equivalents for the three and nine months ended December 31, 2010 and 2009 are summarized in the table below:

Sources and uses of cash	**Three months ended December 31**		**Nine months ended December 31**	
($ millions)	**2010**	**2009**	**2010**	**2009**
Net (loss) earnings	(12.4)	(20.4)	42.8	40.2
Items not involving cash:				
Amortization	28.1	29.5	85.2	85.2
Other non-cash charges	(8.9)	1.6	(7.1)	1.3
Long-term regulatory costs deferred	(1.6)	2.1	(6.9)	8.4
Change in operating working capital	7.9	6.6	(0.4)	(14.4)
Cash provided by operating activities	13.1	19.4	113.6	120.7
Cash used by financing activities	(0.3)	(0.1)	(5.2)	(22.9)
Cash provided by (used in) investing activities	20.4	(24.1)	(23.3)	(60.0)
Total increase (decrease) in cash and cash equivalents	33.2	(4.8)	85.1	37.8

Three Months Ended December 31, 2010

In the three months ended December 31, 2010, cash provided by operating activities included $1.6 million of cash used to reduce long-term regulatory liabilities as follows:

- $1.5 million in fuel rebates granted;
- $0.5 million in fuel and interest costs deferred; and
- $0.1 million in performance term three submission costs;

partially offset by:

- $0.5 million in other payments from the Province credited to deferred fuel accounts.

Cash provided by operating activities also included a decrease in non-cash operating working capital of $7.9 million.

This decrease in non-cash operating working capital was due to:

- $6.4 million decrease in accounts receivable primarily due to $3.4 million in commercial accounts and $2.9 million in social program fees;
- $2.1 million increase in accrued employee costs;
- $1.8 million decrease in prepaid expenses primarily due to $1.4 million in property taxes and $0.6 million in prepaid contracts, partially offset by $0.3 million in insurance;
- $1.6 million increase in accounts payable relating to various operating costs; and
- $0.6 million decrease in total inventories.

The above items, which decreased non-cash operating working capital, were partially offset by:

- $2.9 million decrease in interest payable on long-term debt due to timing of interest payments;
- $1.2 million decrease in current regulatory liabilities reflecting the return to customers through discount fare promotions of tariff revenues collected in excess of price caps at September 30, 2010; and
- $0.5 million reduction in deferred revenue.

Cash provided by investing activities consists mainly of:

- $119.4 million received for remission of import taxes and related GST on our four vessels built in Germany; and
- $11.0 million proceeds from sale of our former corporate office building;

partially offset by:

- $51.4 million purchase of short-term investments;
- $34.4 million used to purchase capital assets; and
- $24.2 million advanced to the developer of our new corporate office.

Nine Months Ended December 31, 2010

In the nine months ended December 31, 2010, cash provided by operating activities included $6.9 million of cash used to reduce long-term regulatory liabilities as follows:

- $8.6 million in fuel rebates granted; and
- $0.1 million in performance term three submission costs;

partially offset by:

- $0.6 million in fuel and interest costs deferred; and
- $1.2 million in other payments from the Province credited to deferred fuel accounts.

Cash provided by operating activities also included an increase in non-cash operating working capital of $0.4 million. This increase in non-cash operating working capital was due to:

- $3.4 million reduction in deferred revenue reflecting the seasonality of our business and expired assured loading tickets;
- $2.8 million decrease in interest payable on long-term debt due to timing of interest payments;
- $0.9 million reduction in accrued employee costs;
- $0.5 million increase in accounts receivable primarily due to $3.2 million receivable from the Province for social program fees and ferry transportation fees, mainly offset by decreases in other miscellaneous receivables; and
- $0.1 million increase in total inventories.

The above items, which increased non-cash operating working capital, were partially offset by:

- $5.5 million increase in current regulatory liabilities reflecting tariff revenues collected in excess of price caps at December 31, 2010;
- $1.1 million increase in accounts payable; and
- $0.7 million decrease in prepaid expenses due to $0.4 million in prepaid service contracts, $0.3 million in miscellaneous prepaids, and $0.1 million in insurance.

Cash used by financing activities consists primarily of $4.5 million in loan principal repayments.

Cash provided by investing activities consists mainly of:

- $119.4 million received for remission of import taxes and related GST on our four vessels built in Germany; and
- $11.0 million proceeds from sale of our former corporate office building;

partially offset by:

- $78.2 million used to purchase capital assets;
- $51.6 million purchase of short-term investments; and
- $24.2 million advanced to the developer of our new corporate head office.

The significant capital transactions are described below in “Investing in Our Capital Assets”.

INVESTING IN OUR CAPITAL ASSETS

Assets acquired under Capital Lease

In September, 2010, agreements which constitute a capital lease for space in our new corporate office building in downtown Victoria took effect following the completion of construction of the new building.

The initial term of the lease is 15 years, with four renewal options of five years each. In November, 2010, we advanced $24.2 million to the developer of the property for a term of 15 years, secured by a second mortgage on the property. The loan agreement provides for interest equal to one-half of the net cash flow from the property, subject to minimum and maximum percentage rates of interest. Over the term of the loan, interest is expected to approximate the market rate when the loan was made. Incidental to the loan, we were granted an option to purchase up to 50% of the owner's equity interest in the new building at a price of $24.2 million. The purchase option expires at the end of the loan term.

Relocation to this property consolidates our head office functions, allowing for operating efficiencies, by combining all departments under one roof. Assets totalling $49.2 million representing the present value of the future minimum payments under these agreements, including the purchase option, have been added to our capital assets in September 2010.

Capital Expenditures

Capital expenditures in the three and nine months ended December 31, 2010, totalled $37.7 million and $89.3 million, respectively.

Capital expenditures
($ millions)

	December 31, 2010	
	3 Months	**9 Months**
Vessel upgrades and modifications	21.4	30.5
Terminal marine structures	7.7	27.9
Terminal and building upgrades and equipment	5.5	17.7
Information technology	3.1	13.2
Total capital expenditures	37.7	89.3

In August 2010, the Government of Canada announced stimulus funding for three projects: an overhead walkway at Horseshoe Bay; a foot passenger walkway at Campbell River; and a waste water facility at Langdale. We expect to receive approximately $2.1 million of the total project costs budgeted at $5.2 million.

On October 1, 2010, the Government of Canada announced that it had granted our request for duty remission on our four vessels built in Germany. Funds totalling $119.4 million (including related GST) were received and have been applied to the capital costs of these four vessels, reducing their net book value.

Our ongoing capital expenditures are expected to be significantly lower than in the previous few years. The next significant vessel renewal program will commence for the other Routes within the next five years. Planning for this program is currently underway.

Vessel Upgrades and Modifications

Capital expenditures for vessel upgrades and vessel modifications in the three and nine months ending December 31, 2010, included the following:

Vessel upgrades and modifications ($ millions)	**December 31, 2010** 3 Months	9 Months
Quadra Queen II life extension	6.3	9.7
Sewage treatment upgrade program	6.0	8.0
Queen of Nanaimo asset betterment	3.6	3.6
Queen of Cumberland interior upgrades	1.6	1.8
Queen of Chilliwack life extension	0.8	1.1
Quinsam upgrade and betterment	0.1	0.9
Evacuation chutes for 3 vessels	0.6	0.8
Electrical & navigational upgrades	-	0.6
Completion of *Queen of Oak Bay* shore power synchronization	-	0.4
Other projects	2.4	3.6
	21.4	30.5

The project to extend the life of the 42-year-old *Quadra Queen II* began in May 2010 and will prepare the vessel for a further 15 years of service. This $15 million project includes hull steel renewal, new propellers and bow thruster, new generators, new instrumentation and control systems, new lifesaving systems and various interior improvements. The *Quadra Queen II* is expected to return to service by the end of this fiscal year. On April 13, 2010, we received approval for up to $1.8 million of additional interest rate support payments through the SFF program relating to this life extension.

Implementation of a multi-year sewage and waste water treatment program to upgrade 20 vessels and eight terminals for treatment of sewage generated onboard the vessels continues. The program involves major modifications and upgrades to ensure that all vessels comply with *Canada Shipping Act, 2001* 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. Modification of the *Skeena Queen, Kwuna, Queen of Nanaimo, Queen of Cumberland* and *Queen of Coquitlam* are complete.

The 47-year-old *Queen of Nanaimo* returned to service on December 17, 2010, after completion of a $4 million asset betterment project in the third quarter. The betterment included steel renewal throughout the vessel and a new exhaust system, among other upgrades.

While undergoing refit in the third quarter, the interior of the *Queen of Cumberland* was upgraded. The $2 million project included upgrades to passenger accommodations and washrooms as well as ergonomic improvements in crew facilities and a change to more efficient surfaces for ease of maintenance. This upgrade is the first phase of a planned mid-life upgrade for this 19-year-old vessel. The balance of the mid-life upgrade is currently scheduled for fiscal 2017.

The project to extend the life of the 33-year-old *Queen of Chilliwack* began in December 2010 with the first phase of a 2-phase project that will allow the vessel to continue in service until it is retired in 2016 or later. The first phase of this $15 million project includes new car deck watertight doors, propeller seals, new instrumentation and control systems, and new lifesaving systems. The *Queen of Chilliwack* is expected to return to service by the end of the first quarter of fiscal 2012.

The 29-year-old *Quinsam* returned to service on May 18, 2010, after completion of an extensive $19 million asset betterment project to prepare the vessel for another 17 years of service. The betterment included hull steel renewal, new lifesaving systems, new electrical switchboard and generators, new right-angle drives, upgrades to the engines, new sewage tank and macerator and various interior improvements. In October 2010, the Government of Canada provided $1.0 million of interest rate support payments relating to the life extension of the *Quinsam* through the SFF program. Of the $1.0 million, $0.1 million was recorded as a reduction of capitalized interest.

Terminal Marine Structures

Capital expenditures for terminal marine structures in the three and nine months ending December 31, 2010 included the following:

Terminal marine structures
($ millions)

Terminal	Description	December 31, 2010 3 Months	December 31, 2010 9 Months
Tsawwassen	Major berth replacement and refurbishment	4.9	19.2
Campbell River	Replacement of wingwalls and dolphins	-	2.0
Richmond Maintenance Facility	Building four new dolphins, reinforcing three others and modifying ramp	0.3	1.6
Swartz Bay	Replacement and reconfiguration of two berths	0.6	1.2
Quathiaski Cove	Replacement of ramp, wingwalls, towers and shelter	0.1	0.8
Sturdies Bay	Replacement of floating lead	0.6	0.7
Various	Other projects	1.2	2.4
		7.7	27.9

The replacement and refurbishment of one of the berths (berth 4) at Tsawwassen terminal is a $39 million multi-year project to replace all 13 dolphins, the port wingwall and the lower ramp. The lower ramp will be replaced with a new multi-apron ramp with two-lane commercial vehicle capacity and the foundations and ramp supports will be upgraded and a new hydraulic lift system installed. The expenditures at Tsawwassen terminal also include $1.5 million of a $5.0 million project for concrete restoration and full seismic upgrade of the transfer deck between berths 3 and 4.

Terminal and Building Upgrades and Equipment

Capital expenditures for terminal and building upgrades and equipment in the three and nine months ending December 31, 2010 included the following:

Terminal and building upgrades and equipment
($ millions)

	December 31, 2010 3 Months	December 31, 2010 9 Months
Corporate head office	1.8	6.0
Terminal waste water program	1.5	4.1
Vehicles, machinery & equipment	0.7	1.9
Departure Bay terminal improvements	0.4	1.5
Seismic upgrades	0.2	1.2
Security upgrades	0.2	0.6
Maintenance facility improvements	0.2	0.6
Other terminal projects	0.5	1.8
	5.5	17.7

At our new corporate head office building, we have made leasehold improvements including security and sound masking systems and an emergency generator. We've also installed movable walls, signage and furniture.

As part of the multi-year sewage and waste water treatment program for treatment of sewage generated onboard our vessels, connection of Swartz Bay terminal to the existing municipal infrastructure has been completed, allowing us to transfer sewage from our smaller vessels operating out of this terminal. Construction of a holding tank at the terminal to accommodate sewage from our larger vessels is also complete and is expected to be in service by the end of this fiscal year. This will allow transfer to the municipal infrastructure to occur during off-peak periods. As part of the Federal government's Infrastructure Stimulus Fund program, we received $2.2 million in December 2010 to assist with sewage pump-ashore projects and other major terminal projects. We estimate that we will receive a total of $9.2 million relating to these projects.

The costs incurred for vehicles, machinery, and equipment include the purchase of a crane truck in the third year of our five-year heavy vehicle replacement program. This new vehicle replaced an 18-year-old crane truck which we donated to Camosun College of Victoria for use in their heavy duty mechanics program. We also continued with the second year of our two-year program supporting our new drop trailer service with the purchase of three additional hostling units. These units will be used to move commercial trailers to and from our holding compounds.

We are nearing completion of our multi-year program in accordance with our master plan for improvements at Departure Bay terminal. These improvements have included new retail and ticket buildings, a new waiting room, consolidation of waste management facilities and expansion of customer and employee parking. Reconfiguration of the holding compound and employee and customer parking lots are also now complete. Construction of a canopy will be completed next fiscal year.

As part of multi-year projects to upgrade our facilities, the office and warehouse buildings at our Nanaimo terminal maintenance facility as well as the pre-boarding building at our Tsawwassen terminal have undergone seismic upgrades.

At nine terminals, mainly serving our Major and Northern Routes, we continued our multi-year project to upgrade 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. We received $3.2 million in the first quarter of fiscal 2011, bringing the total to $9.1 million of federal funding through the Transport Canada Marine Security Contribution Program to help offset our costs of perimeter security, access control measures, and training.

Information Technology

Capital expenditures for information technology in the three and nine months ending December 31, 2010, included the following:

Information technology
($ millions)

	December 31, 2010	
	3 Months	**9 Months**
Oracle enterprise licence software	-	4.1
Payroll system replacement	0.7	2.2
Customer service program	0.5	1.3
Computer hardware upgrades	0.3	1.1
Website enhancements	0.2	0.7
Communications software	0.1	0.6
ERP foundation upgrades	0.1	0.6
Other projects	1.2	2.6
	3.1	13.2

As part of our ongoing processes, we have reviewed and updated our enterprise wide Oracle licences.

The payroll system replacement initiative will replace both our payroll and labour distribution systems to provide added reliability and significant processing efficiencies and flexibility.

The customer service program will replace our aged point of sale and reservations systems, and allow us to respond in a more timely fashion to changing business needs and to support marketing, travel services, and pricing initiatives. This program will also include terminal ticketing automation and customer relationship management systems. The planning for this multi-year program is in the preliminary stages.

Computer hardware upgrades continue as we proceed through our programs for replacement of aged computers, servers and printers.

The website initiative is a $4 million project to improve customer service and communications tools, both internally and externally, and to establish a technical platform to enable future web enhancements.

Other projects include automated wireless ticketing and bridge team simulator training. In September 2010, we introduced wireless hand-held point-of-sale units on Denman Island, Quadra Island and Saturna Island where transactions were previously processed manually. This has allowed us to eliminate prepaid paper tickets on these routes and has enabled customers to use credit cards or their BC Ferries Experience Cards to purchase fares.

We have started our bridge team simulator training project that will implement training simulators at three of our major terminals. This will allow us to provide low-risk, affordable, and sustainable simulation training in individual and team skills for bridge personnel.

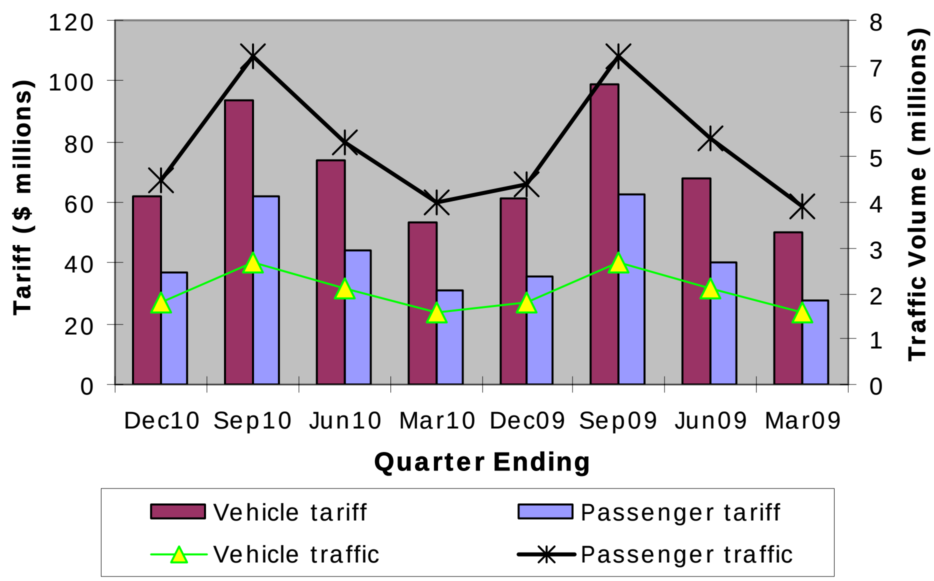
SUMMARY OF QUARTERLY RESULTS

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

	Quarter Ended (unaudited)							
($ millions)	**Dec 10**	**Sep 10**	**Jun 10**	**Mar 10**	**Dec 09**	**Sep 09**	**Jun 09**	**Mar 09**
Total revenue	162.3	246.0	190.2	142.3	159.9	251.8	178.3	128.5
(Loss) earnings from operations	(3.3)	72.4	18.9	(19.5)	(1.9)	81.5	12.2	(25.1)
Net (loss) earnings and comprehensive income	(12.4)	54.3	0.9	(36.8)	(20.4)	64.2	(3.6)	(38.4)

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 reduction 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 35 through 37 of our fiscal 2010 Management's Discussion & Analysis. Our risk profile is substantially unchanged during the nine months ended December 31, 2010.

BUSINESS RISK MANAGEMENT

Understanding and managing operational risk is an important part 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 38 through 45 of our fiscal 2010 Management's Discussion & Analysis. Our risk profile is substantially unchanged during the nine months ended December 31, 2010.

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 ensure 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, 2010 and December 31, 2010 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 46 through 48 of our fiscal 2010 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 three and nine months ended December 31, 2010, or expect to use in the future.

Adoption of New Accounting Standards

No new accounting standards have been adopted for fiscal 2011.

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 IFRS over an expected five year transitional period.

  Our changeover date for the conversion to IFRS was originally April 1, 2011. However, the AcSB has amended Part 1 of the CICA Handbook – Accounting to require:
  - Qualifying entities with rate-regulated activities to adopt IFRSs for the first time no later than annual periods beginning on or after January 2012; and
  - Entities electing to defer the first-time adoption of IFRSs to disclose that fact.

  The Canadian Securities Administrators' regulations have also been amended to incorporate the AcSB's one-year deferral.

  We have elected this option which defers our changeover date for conversion to IFRS to April 1, 2012.

  Transition to IFRS will require the restatement for comparative purposes of amounts reported by us for the year prior to changeover date. 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 AcSB 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, we are unable to quantify the impact of IFRS on the future financial position and results of operations.

  We commenced our IFRS transition 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 transition project consists of three phases:
  1. Scoping and diagnostic phase, which has been completed, involved project planning and resourcing, high level impact assessment of differences between current Canadian GAAP and IFRS, and priority setting;
  2. Analysis and development phase which involves detailed analysis and evaluation of options and alternative methodologies available under IFRS, and the financial impact of these options; and
  3. Implementation and review phase which involves implementing and approving changes to accounting policies, information systems, business processes and training, and developing IFRS-compliant financial statements.

  We are currently in either the analysis and development stage or the implementation and review stage, depending on the specific area.

  The following table includes elements of our IFRS transition plan and an assessment of progress towards achieving the key milestones which have been amended to reflect our election to defer our changeover to IFRS by one year, to April 1, 2012. 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.

Financial statement preparation
Key activities • Identify differences in Canadian GAAP/IFRS accounting policies • Select ongoing IFRS policies • Develop financial statement format • Select IFRS 1 exemptions for transition • Quantify effects of change at April 1, 2011 (for fiscal 2012 comparative financial statements)
Milestones • Senior management review of policy decisions and illustrative IFRS financial statements and disclosures by June 30, 2011 • Audit & Finance Committee approval of policy decisions and IFRS financial statement format, in principle, by September 30, 2011 • IFRS 1 exemptions finalized and quantified by September 30, 2011 • Policies and procedures in place by March 31, 2012
Status • 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; review prioritized; and in-depth analysis complete • Accounting policy alternatives have been analyzed and recommendations made for key accounting policy decisions • IFRS 1 exemptions reviewed and analyzed • Preparation of illustrative financial statements and note disclosures complete • Drafting of policies and procedures in progress

Information technology infrastructure
Key activities • Confirm system upgrades required for IFRS reporting • Review/revise data gathering processes • Review/revise budgeting and forecasting processes
Milestones • System configuration changes complete by March 31, 2010 • System reporting changes required to accommodate both current Canadian GAAP and IFRS complete by August 31, 2010 • Changes to budgeting and forecasting processes complete by June 30, 2011
Status • Detailed reporting requirements to accommodate the transition to IFRS identified and documented • Overall system approach selected • System configuration to accommodate both current Canadian GAAP and IFRS complete • System changes to accommodate reporting requirements complete • Review to determine effects on the project of one-year deferral of changeover and absence of standard on rate-regulation complete • Changes to budgeting and forecasting processes in progress

Training, Education & Communication
Key activities • 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 • Provide department specific training on revised policies and procedures • Provide timely communication to both internal and external stakeholders on impacts of the transition to IFRS
Milestones • Topic-specific training for IFRS working committee complete prior to March 31, 2010 • Department-specific training completed by March 31, 2012 • Impacts of transition to IFRS communicated to external stakeholders by March 31, 2012
Status • Core IFRS project team members completed topic-specific training, and successfully completed the "IFRS Award Program, Certificate Level" through the Institute of Chartered Accountants in England and Wales • Interdepartmental workshops provided on specific topics, including property, plant and equipment; IFRS 1; and the IFRS Framework • Training requirements identified and training plan developed for the majority of stakeholders • Ongoing communications with key stakeholders, including direct communication with the Commissioner, our Agent Bank, rating agencies, our Board of Directors, and with investors indirectly through our website

Control environment
Key activities • Accounting policy determination, documentation and implementation • MD&A ongoing communications
Milestones • All internal control process descriptions updated by March 31, 2012 • Publish quantitative effects of conversion on April 1, 2011 opening balance sheet in December 31, 2011 MD&A
Status • Analysis of control issues in progress as part of the detailed implementation plan • Documentation of policies and procedures nearing completion

Business policy assessment
Key activities • Financial covenants assessment • Compensation arrangements assessment • Customer and supplier contract evaluation
Milestones • Potential impact on compensation arrangements determined by December 31, 2011 • Impact on customer/supplier contracts determined by December 31, 2011 • Impact on financial covenants quantified by March 31, 2012
Status • All relevant GAAP-dependent covenants and contracts have been identified • Analysis to determine effects of IFRS on existing covenants and contracts in progress

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

- Rate-regulated operations: IFRS does not currently provide specific guidance with respect to accounting for rate-regulated activities. In December 2008, the International Accounting Standards Board (IASB) initiated a project on accounting for rate-regulated activities that had an objective to develop a standard on rate-regulated activities that would clarify whether regulated entities could or should recognize assets or liabilities as a result of rate-regulation imposed by a regulatory body.

  In September 2010, the IASB staff released Agenda Paper 12 on rate-regulated activities. In the staff's opinion, while the impact of regulators may have an economic impact on entities subject to rate-regulation:
  - Regulatory assets do not meet the definition of a financial asset nor the definition of an intangible asset as specified in IAS 38; and
  - Regulatory liabilities do not meet the definition of a financial liability nor the definition of a provision as specified in IAS 37.

  This project on rate-regulated activities has been closed and the IASB plans to consult constituents in 2011 on whether issues relating to rate-regulated activities should be considered in a new project in its post-2011 agenda.

  It is our expectation that issues regarding rate-regulated activities will remain unresolved for some time and that we will not be reporting our regulatory assets or liabilities on the IFRS Statement of Financial Position. Accordingly, our regulatory assets or liabilities will be derecognized on our transition date of April 1, 2011. As future balances of our regulatory accounts are uncertain, we cannot reasonably estimate and conclude the impact on our future financial position and results of operations with respect to accounting for rate-regulated activities.

- Property, plant and equipment:
  - *Inspections and major overhauls:* The capitalization of inspections and major overhauls of our vessels is a significant change affecting us. A process to track these items has been finalized and necessary system configuration changes have been completed. We have defined and identified inspection and major overhaul items for each class of vessel and are in the process of quantifying them for reclassification at transition date. We are also currently working on internal reporting solutions. As the quantification is in progress, the effect on our consolidated financial statements of the adoption of this guidance cannot be quantified at this time.
  - *Valuation subsequent to transition:* We have a choice under IFRS to value our property, plant and equipment using either a historical cost model or a revaluation model. We have decided to use a historical cost model for all property, plant and equipment with the exception of land. We will use a revaluation model for our land.

- IFRS 1 *First-Time Adoption of IFRS*: All elections and exemptions under IFRS 1 have been reviewed. The exemptions that apply to us upon adoption are summarized as follows:
  - *Employee Benefits:* There is a choice to either recognize all cumulative actuarial gains and losses of defined benefit plans through opening retained earnings or recalculate the actuarial gains and losses under IFRS from the inception of the defined benefit plans. We have elected to recognize all cumulative actuarial gains and losses through opening retained earnings at April 1, 2011.

- *Property, plant and equipment and Intangible assets:* There is a choice of valuation of property, plant and equipment and intangible assets at April 1, 2011, either to:
  - retrospectively apply IFRS to the valuation of the assets; or
  - to revalue items, on an asset by asset basis, at fair value and use that fair value as deemed cost; or
  - use previous GAAP carrying amounts at transition as the deemed cost for assets used in rate-regulated operations as detailed in the amendment to IFRS 1 published May 6, 2010.

  We have elected to use previous GAAP carrying amounts at transition as the deemed cost for all intangible assets and the majority of our property, plant and equipment with the exception of land. We have elected to revalue land at fair value at April 1, 2011. This revaluation will result in an increase in land value of $12.2 million.

As actuarial valuations of our defined benefit plans at April 1, 2011 are yet to be completed and land has not been fair valued, the effect on our consolidated financial statements of the adoption of IFRS 1 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: Policies and processes regarding asset impairment and potential subsequent reversals have been completed. The adoption of this guidance is not expected to have any significant effect on our consolidated financial statements.

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, fluctuating financial markets, demographics, tax changes, and the requirements of the Coastal Ferry Services Contract.

Forward looking statements included in this document include statements with respect to traffic levels, our short-term and long-range business plans, our asset renewal programs for vessels and terminals, and how our cash requirements will be met; expectations regarding the impacts of the harmonized sales tax, certain Transport Canada mandates, and costs associated with Bill 20; expectations of an operational loss in fiscal 2011, a new loss in fiscal 2012 and a return to profitability in 2013; estimates of future customer demand, expectations of ferry transportation fee amounts, funding under the Infrastructure Stimulus Fund program, price cap increases, and the impacts of IFRS. 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, limitations of vessel repair facilities, 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 except as may be required by applicable law.