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

For the three and six months ended September 30, 2011
Dated October 28, 2011

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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 October 28, 2011. 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, 2011 and 2010, and our audited consolidated financial statements and related notes for the years ended March 31, 2011 (fiscal 2011) and March 31, 2010 (fiscal 2010), together with our fiscal 2011 Management's Discussion & Analysis. These documents are available on SEDAR at www.sedar.com and on our Investor webpage at http://www.bcferries.com/about/investors/index.html.

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 35 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 September 30, 2011 (the second quarter of fiscal 2012), we provided 49,500 sailings, carrying 7.0 million passengers and 2.6 million vehicles.

In the second quarter of fiscal 2012, we experienced a decline of 3.5% (3.4% year-to-date) in vehicle traffic and 2.9% (2.9% year-to-date) in passenger traffic as compared to the same periods in the prior year. This is the largest year-over-year traffic decline we've experienced in recent years, and is the lowest vehicle traffic we've experienced in 11 years and the lowest passenger traffic we've experienced in 20 years. The decline in vehicle and passenger traffic was experienced across the Major, Northern and Other routes. (See discussion under "Financial and Operational Review" below).

Significant events during or subsequent to our second quarter of fiscal 2012:

- On July 26, 2011, we announced a 90-day, one-time only refund to customers who purchased assured loading tickets between 1984 and July 25, 2011 and no longer want the tickets. This decision was made prior to completion of fiscal 2011 and a liability was reflected in the fiscal 2011 financial statements to provide for these refunds. We received approximately 3,500 refund requests during the 90-day period and are currently validating and processing these requests. We expect that the liability established will be sufficient to substantially provide for the total value of these refunds.

- On August 18, 2011, we received approval from the Department of Fisheries and Oceans under the *Canadian Environmental Assessment Act* for our cable ferry project and, as a result, are proceeding to the next stage of this initiative. In fiscal 2011, we completed our review of the feasibility of using cable ferry technology on one of our shortest routes. We determined that using a cable ferry is technically, operationally and financially feasible. Cable ferries are a proven technology that uses small engines in combination with drive and guide cables to move the vessel. They are less costly to own and operate due to their comparative simplicity, high operational reliability, lower capital cost, smaller crew and lower fuel consumption. The cable ferry would be operated by us or by a private operator under contract to us. Regardless of the operator, we would ensure the safety, quality and performance standards of the operation. We are currently in consultation with the public regarding this initiative and expect to have a final decision in 2012.

- On September 15 and 22, 2011, we paid down $45 million in debt consisting of the principal amounts outstanding under the second tranche of the two 12-year, 4.98% loans with the KfW bank group (KfW). These loan agreements were also amended to transfer the principal payments on these loans for the next three years to the second tranche, on which interest only is paid at a floating rate. The principal on the second tranche is due at maturity. (See "Liquidity and Capital Resources" for more detail.)

- On September 27, 2011, our Board announced that our President and CEO elected to retire effective December 31, 2011.

- On September 27, 2011, we announced a cost containment strategy to respond to lower than anticipated traffic levels and the resulting revenue reduction. This strategy includes a hiring freeze of all non-essential positions, a two-year wage and salary freeze, cancellation of discretionary expenses, reduced use of outside contractors and consultants, and elimination of many charitable and community donations. We also applied to the Province to reduce up to 400 round trips annually on our major routes. This is approximately 4% of the total annual round trips we make on these routes.

- On September 28, 2011, we launched our new bridge simulator training facilities at three of our major terminals. The state-of-the-art bridge simulators will enable the development and delivery of affordable, integrated and targeted bridge team training that reduces operational risk. The training program will leverage simulator best practices, minimize operational impacts and overhead, establish the infrastructure and lay the foundation for technical and team training for our bridge teams.

FINANCIAL AND OPERATIONAL OVERVIEW

This section provides an overview of our financial and operational performance for the three and six months ended September 30, 2011 and 2010:

($ millions)	Three months ended September 30			Six months ended September 30		
	2011	**2010**	**Variance**	**2011**	**2010**	**Variance**
Total revenue	252.1	246.0	6.1	438.7	436.2	2.5
Operating expenses	(176.7)	(173.6)	(3.1)	(350.9)	(344.9)	(6.0)
Earnings from operations	75.4	72.4	3.0	87.8	91.3	(3.5)
Interest and other	(18.1)	(18.1)	-	(36.0)	(36.1)	0.1
Net earnings and comprehensive income	57.3	54.3	3.0	51.8	55.2	(3.4)

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 commercial and discretionary travel markets continue to be negatively impacted by economic conditions including high vehicle fuel prices, a high Canadian dollar and generally reduced consumer confidence. In the six months ending September 30, 2011, our vehicle traffic levels were the lowest they've been in 11 years and our passenger traffic levels were the lowest they've been in 20 years. We do not anticipate that economic conditions or our traffic levels will improve in the near term. We do expect vehicle and passenger traffic this fiscal year to be lower than that of the prior year.

We had planned for a net loss estimated to be in the range of $20 million for this fiscal year, largely driven by significantly lower traffic levels than those included in setting our performance term two price caps. Although lower traffic levels are the major driver, other contributing factors to this loss are such items as the harmonized sales tax, additional Transport Canada requirements and freedom of information overhead expenses and other costs associated with the October 1, 2010 amendments to the *Coastal Ferry Act* (the Act) resulting from the *Miscellaneous Statutes Amendment Act (No. 3), 2010*. As the traffic levels in the first and second quarters were even lower than originally anticipated, we believe that the net loss for this fiscal year will be larger than originally estimated. In response to the reduced traffic levels and larger expected loss, we have implemented a major cost containment program, and have applied to the Province to reduce up to 400 round trips annually on our major routes.

In March 2011, the British Columbia Ferries Commissioner (the Commissioner) set preliminary price cap increases for each of the four years of performance term three of 4.15% on the Major Routes and 8.23% on all other routes, effective April 1, 2012. In making these determinations, the Commissioner excluded certain of our forecast costs and incorporated a productivity challenge effectively further reducing our allowed costs. Financial conditions have deteriorated from those existing when the submission was made in September 2010.

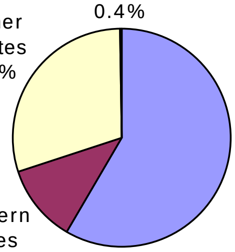
On May 19, 2011, the Province and the Commissioner announced a review of the Act to identify improvements which would better allow the Commissioner to balance the interests of ferry users with the financial sustainability of our company. On June 2, 2011, *Coastal Ferry Amendment Act*, *2011 (*Bill 14) was enacted. This legislation provides the Commissioner with the mandate to conduct the review of the Act in the timeline established for this purpose. We are providing full cooperation to the Commissioner and we are in favour of any opportunity to look at ways to ensure the provision of affordable ferry fares, while still protecting the long term financial viability of our company. The Commissioner's recommendations are due to the B.C. Minister of Transportation and Infrastructure by January 24, 2012, as to how the Act could be amended to allow the Commissioner to balance the interests of ferry users with the financial sustainability of our company.

Effective April 1, 2012, for the first year of performance term three, Bill 14 established a price cap increase for each route group of 4.15% from the weighted average of the tariffs in place at March 31, 2012 (as established by the Commissioner). Bill 14 also prevents us from obtaining extraordinary price cap increases as a result of unanticipated changes such as a significant deterioration in traffic levels, as we would have been permitted to do under the Act. Our current average fares on the non-Major routes do not provide the full revenue allowed by the current price caps.

There is uncertainty related to the outcome of the Commissioner's review of the Act. We had expected to return to profitability in fiscal 2013, however, traffic levels much lower than anticipated in the performance term three submission and the constraints of Bill 14 will negatively impact our future financial performance.

Revenue

Total revenues for the three months ended September 30, 2011 increased 2.4% (0.6% year-to-date) over the same periods in the previous year as shown in the table below:



In the six months ended September 30, 2011, 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 30%.

Revenue ($ millions)	**Three months ended September 30** 2011	2010	Increase (Decrease)	**Six months ended September 30** 2011	2010	Increase (Decrease)
Direct Route Revenue						
Vehicle traffic (volume)	*2,559,823*	*2,652,605*	*(92,782)*	*4,589,152*	*4,751,640*	*(162,488)*
Vehicle tariff	97.1	93.9	3.2	169.3	167.8	1.5
Passenger traffic (volume)	*7,001,389*	*7,210,210*	*(208,821)*	*12,173,848*	*12,537,804*	*(363,956)*
Passenger tariff	64.9	61.8	3.1	108.1	106.1	2.0
Social program fees	7.4	6.6	0.8	14.6	13.2	1.4
Catering & on-board	26.5	27.5	(1.0)	45.5	47.3	(1.8)
Other revenue	7.5	9.0	(1.5)	12.4	15.3	(2.9)
Total Direct Route Revenue	203.4	198.8	4.6	349.9	349.7	0.2
Indirect Route Revenue						
Ferry transportation fees	41.1	39.7	1.4	73.3	71.6	1.7
Federal-Provincial subsidy	6.8	6.8	-	13.7	13.5	0.2
Total Route Revenue	251.3	245.3	6.0	436.9	434.8	2.1
Other general revenue	0.8	0.7	0.1	1.8	1.4	0.4
Total Revenue	252.1	246.0	6.1	438.7	436.2	2.5

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, 2011, the price caps increased by 3.38% on the Major Routes and 6.71% on all other routes. These price cap increases reflect a change in the CPI (British Columbia) of 1.39%. In response to the changes, we implemented tariff increases up to the new levels authorized.

Effective October 18, 2010, we implemented an across the board fare reduction of approximately 2% as a result of $119.4 million in duty remission and related GST announced by the Government of Canada on October 1, 2010.

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.

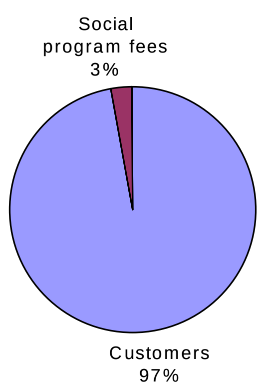
A fuel surcharge of 2.5% of tariffs on average on our Major Routes and 5% of tariffs on average on many of our other routes was implemented June 1, 2011 due to the rising cost of fuel. No fuel surcharges or rebates were in place on our Northern Routes.

Year to year changes for the three and six months ended September 30 for our 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**		
	2011	**2010**	**Increase (Decrease)**	**2011**	**2010**	**Increase (Decrease)**
Vehicle traffic (volume)	*1,203,129*	*1,260,014*	*(56,885)*	*2,125,393*	*2,213,396*	*(88,003)*
Vehicle tariff	71,004	67,396	3,608	124,337	122,251	2,086
Passenger traffic (volume)	*3,723,501*	*3,856,470*	*(132,969)*	*6,398,311*	*6,603,809*	*(205,498)*
Passenger tariff	45,960	42,791	3,169	77,212	74,930	2,282
Social program fees	3,755	3,409	346	7,179	6,576	603
Catering & on-board	20,898	21,813	(915)	36,515	38,042	(1,527)
Reservation fees	4,214	4,945	(731)	6,829	7,793	(964)
Parking	1,122	1,411	(289)	2,037	2,133	(96)
Assured loading	494	962	(468)	970	2,773	(1,803)
Other revenue	676	633	43	1,193	1,072	121
Total Direct Route Revenue	148,123	143,360	4,763	256,272	255,570	702
Indirect Route Revenue						
Ferry transportation fees	-	-	-	-	-	-
Federal-Provincial subsidy	-	-	-	-	-	-
Total Route Revenue	148,123	143,360	4,763	256,272	255,570	702

Our Major Routes consist of three regulated routes connecting Greater Vancouver with mid and southern Vancouver Island. In the three and six months ended September 30, 2011, vehicle traffic decreased by 4.5% (4.0% year-to-date) and passenger traffic decreased by 3.4% (3.1% year-to-date), compared to the same periods in the previous year. Annual traffic levels on these routes are anticipated to be lower than the prior fiscal year.



In the six months ended September 30, 2011, revenue from our Major Routes consisted of 97% from customers and 3% from social program fees.

On June 2 through June 26, 2011, our “CoastSaver” program was in place, providing price discounts of more than 30% on passenger and passenger vehicle fares from Thursday through Sunday each week through the duration of the program. Despite this incentive program, traffic on these routes declined. This further reinforced our view that, while the level of ferry fares may be a contributing factor, other external factors are primarily responsible for declining traffic levels.

Major Routes, cont'd

Average tariff revenue per vehicle increased $5.53 or 10.3% in the quarter ($3.27 or 5.9% year-to-date) compared to the prior year. Average tariff revenue per passenger increased $1.24 or 11.2% ($0.72 or 6.3% year-to-date). Fares collected during the second quarter of the prior year were in excess of price cap. At September 30, 2010, $6.7 million was reflected on the balance sheet as a regulatory liability. The higher average fares more than offset the reduction in traffic, resulting in an increase of $6.8 million ($4.4 million year-to-date) in tariff revenue.

On June 1, 2011, fuel surcharges of 2.5% of tariffs on average were put in place on the Major Routes 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 program usage and higher fares. Neither ferry transportation fees nor Federal-Provincial subsidies are received in support of services provided on our major routes.

All vessels that provide service on our Major Routes have a gift shop and options for food service. Both food and gift shop sales decreased as a result of lower passenger traffic. In our gift shops, sales of quality apparel remain strong with an increase of more than 12% year-to-date.

The decrease in parking revenue reflects both lower passenger traffic and the impact of changes in transit services both on Vancouver Island and on the mainland.

The year-to-date decrease in assured loading revenue reflects the lower traffic levels and a gain recognized in the first quarter of the prior year relating to expired tickets. The gain was reversed in the fourth quarter of fiscal 2011 upon the decision to restore the value of these expired tickets. The annual assured loading revenue in fiscal 2012 is expected to be lower than the prior year.

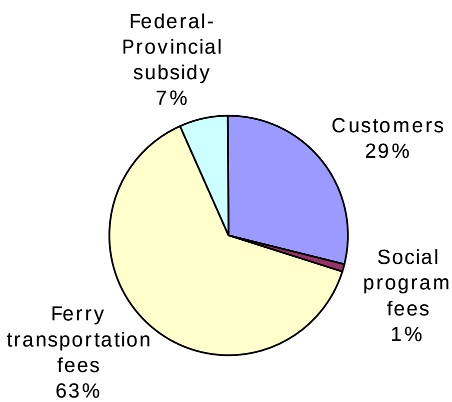
Other revenue increased mainly as a result of an increase in hostling[1] fees from our drop-trailer service for commercial customers.

[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 September 30**			**Six months ended September 30**		
	2011	**2010**	**Increase (Decrease)**	**2011**	**2010**	**Increase (Decrease)**
Vehicle traffic (volume)	*13,353*	*14,736*	*(1,383)*	*19,901*	*21,895*	*(1,994)*
Vehicle tariff	4,191	4,416	(225)	6,119	6,365	(246)
Passenger traffic (volume)	*42,264*	*46,674*	*(4,410)*	*60,107*	*66,370*	*(6,263)*
Passenger tariff	4,421	4,673	(252)	6,016	6,402	(386)
Social program fees	335	345	(10)	622	649	(27)
Catering & on-board	1,318	1,366	(48)	1,788	1,895	(107)
Stateroom rental	424	423	1	677	700	(23)
Hostling & other	80	77	3	120	130	(10)
Total Direct Route Revenue	10,769	11,300	(531)	15,342	16,141	(799)
Indirect Route Revenue						
Ferry transportation fees	19,858	18,448	1,410	32,369	30,684	1,685
Federal-Provincial subsidy	1,700	1,665	35	3,400	3,330	70
Total Route Revenue	32,327	31,413	914	51,111	50,155	956

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, 2011, revenue from our Northern Routes consisted of 29% from customers and 71% from the Province (1% social program fees, 63% ferry transportation fees, and 7% from payments under the Federal-Provincial subsidy agreement).

In the three and six months ended September 30, 2011, vehicle traffic decreased 9.4% (9.1% year-to-date) and passenger traffic decreased 9.4% in both the quarter and year-to-date, compared to the same periods in the previous year. Annual traffic levels on these routes are also anticipated to be lower than the prior fiscal year.

The average tariff revenue per vehicle increased $14.19 or 4.7% ($16.76 or 5.8% year-to-date) while the average tariff revenue per passenger increased $4.48 or 4.5% ($3.63 or 3.8% year-to-date). The reduction in traffic more than offset the increase in average rates, resulting in a total tariff revenue decrease for the quarter of $0.5 million ($0.6 million year-to-date).

Reimbursements from the Province for social program fees decreased marginally as a result of lower usage, partially offset by higher average fares.

Northern Routes, cont'd

Revenue from catering and on-board services decreased as a result of lower traffic levels.

Stateroom rental, hostling and other increased marginally in the second quarter compared to the same quarter of the prior year due to higher usage. For the six months ended September 30, 2011, these revenues remained lower than the prior year.

We receive ferry transportation fees for these routes under the Coastal Ferry Services Contract. These fees are higher in the quarter, reflecting an increase in funding this fiscal related to the *Queen of Chilliwack* life extension, partially offset by the impact of lower net book value of the vessels used on these routes. The transportation fees decrease as these vessel assets are amortized. The total annual transportation fees are expected to be $1.4 million higher than the prior fiscal year.

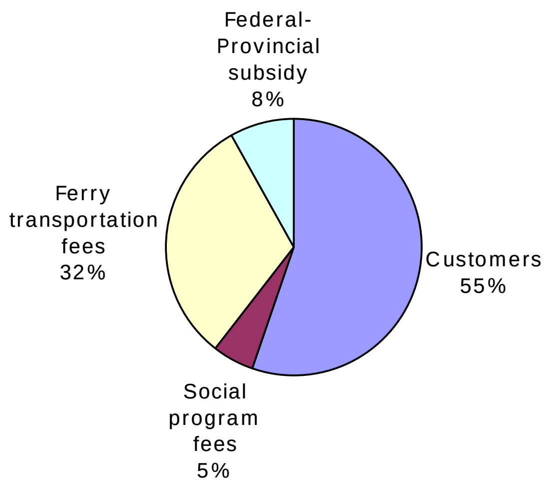
The Federal-Provincial subsidy has increased by the change in the annual CPI (Vancouver).

Other Routes

Direct Route Revenue ($ thousands)	**Three months ended September 30**			**Six months ended September 30**		
	2011	**2010**	**Increase (Decrease)**	**2011**	**2010**	**Increase (Decrease)**
Vehicle traffic (volume)	*1,343,341*	*1,377,855*	*(34,514)*	*2,443,858*	*2,516,349*	*(72,491)*
Vehicle tariff	21,868	22,022	(154)	38,884	39,162	(278)
Passenger traffic (volume)	*3,235,624*	*3,307,066*	*(71,442)*	*5,715,430*	*5,867,625*	*(152,195)*
Passenger tariff	14,541	14,411	130	24,891	24,811	80
Social program fees	3,298	2,900	398	6,778	6,011	767
Catering & on-board	3,866	3,907	(41)	6,506	6,620	(114)
Reservation fees	644	760	(116)	942	1,088	(146)
Parking & other	171	164	7	258	276	(18)
Total Direct Route Revenue	44,388	44,164	224	78,259	77,968	291
Indirect Route Revenue						
Ferry transportation fees	21,210	21,305	(95)	40,920	41,018	(98)
Federal-Provincial subsidy	5,172	5,066	106	10,344	10,132	212
Total Route Revenue	70,770	70,535	235	129,523	129,118	405

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.

Other Routes, cont'd



In the six months ended September 30, 2011, revenue from our Other Routes consisted of 55% from customers and 45% from the Province (5% social program fees, 32% ferry transportation fees, and 8% from payments under the Federal-Provincial subsidy agreement).

In the three and six months ended September 30, 2011, vehicle traffic decreased 2.5% (2.9% year-to-date) and passenger traffic decreased 2.2% (2.6% year-to-date), compared to the same periods in the previous year. Annual traffic levels on these routes are also anticipated to be lower than the prior fiscal year.

The average tariff revenue per vehicle increased $0.30 or 1.9% ($0.35 or 2.2% year-to-date) while the average tariff revenue per passenger increased $0.13 or 3.0% ($0.13 or 3.1% year-to-date). The reduction in vehicle traffic more than offset the increase in average fares, resulting in lower vehicle tariff revenue for the quarter of $0.2 million ($0.3 million year-to-date). The higher average passenger fares more than offset the reduction in traffic, resulting in an increase of $0.1 million ($0.1 million year-to-date) in passenger tariff revenue.

On June 1, 2011, fuel surcharges of 5% of tariffs on average were put in place on the majority of these routes due to the increasing cost of fuel.

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

Revenue from catering and on-board services decreased mainly as a result of lower traffic levels.

Fees for reservations decreased primarily as a result of lower traffic levels on routes where those services are offered.

An increase in other revenue from the installation of additional cash dispensing machines was partially offset by a reduction in parking revenue year-to-date.

Total annual ferry transportation fees are expected to equal that of the prior fiscal year.

The Federal-Provincial subsidy has increased by the change in the annual CPI (Vancouver).

Expenses
Expenses for the three and six months ended September 30, 2011 and 2010 are summarized in the tables below:

Operating expenses ($ millions)	**Three months ended September 30**			**Six months ended September 30**		
	2011	**2010**	**Increase (Decrease)**	**2011**	**2010**	**Increase (Decrease)**
Operations	114.6	114.9	(0.3)	219.6	218.5	1.1
Maintenance	14.2	12.6	1.6	39.2	36.5	2.7
Administration	8.4	7.3	1.1	15.8	14.8	1.0
Total operations, maintenance & administration	137.2	134.8	2.4	274.6	269.8	4.8
Cost of retail goods sold	10.0	10.3	(0.3)	17.4	18.0	(0.6)
Amortization	29.5	28.5	1.0	58.9	57.1	1.8
Total operating expenses	176.7	173.6	3.1	350.9	344.9	6.0

In the second quarter, the $0.3 million decrease in operations expense consists of a reduction in insurance costs of $0.8 million and a reduction of $1.1 million in many other operational areas, partially offset by an increase in fuel expense of $1.6 million or 5.8%. Year-to-date, the $1.1 million increase consists mainly of an increase in fuel expense of $3.1 million or 6.0% as a result of higher approved fuel prices, partially offset by a 0.7% reduction in fuel consumption, a $0.6 million reduction in insurance costs, $0.6 million in advertising, mail and telecommunications costs, and a further $0.8 million reduction in many other operational areas.

The $1.6 million ($2.7 million year-to-date) increase in maintenance costs reflects an increase in vessel maintenance as a result of variations in vessel refit scheduling, partially offset by lower terminal maintenance.

The $1.1 million ($1.0 million year-to-date) increase in administration expenses is mainly due to higher wages and benefits and other contracted charges. The increase in benefits was primarily as a result of a new actuarial valuation of our WCB unfinalized claims liability while the increase in wages was due to employee contract settlements and other factors, partially offset by staff vacancies.

The $0.3 million ($0.6 million year-to-date) decrease in cost of retail goods sold reflects the decrease in sales.

Amortization increased a total of $1.0 million ($1.8 million year-to-date), reflecting a $0.9 million ($0.4 million year-to-date) increase in vessel amortization and a $0.1 million ($1.4 million year-to-date) increase in terminal amortization reflecting the assets that have come into service. (See “Investing in our Capital Assets” below for more detail.)

Interest and other ($ millions)	**Three months ended September 30**			**Six months ended September 30**		
	2011	**2010**	**Increase (Decrease)**	**2011**	**2010**	**Increase (Decrease)**
Interest expense						
Bond interest	16.0	16.0	-	31.8	31.8	-
KfW loans	2.4	2.6	(0.2)	5.0	5.3	(0.3)
Interest on capital lease	0.6	-	0.6	1.1	-	1.1
Short-term loans	0.1	-	0.1	0.1	0.1	-
Interest on deferred accounts	-	0.1	(0.1)	0.1	0.2	(0.1)
Structured Financing Facility Program	(0.4)	(0.2)	(0.2)	(0.9)	(0.2)	(0.7)
Capitalized interest	(0.5)	(0.6)	0.1	(1.0)	(1.2)	0.2
Total interest expense	18.2	17.9	0.3	36.2	36.0	0.2
Gain on foreign exchange	(0.1)	-	(0.1)	(0.2)	(0.1)	(0.1)
Loss on disposal of capital assets	-	0.2	(0.2)	-	0.2	(0.2)
Total interest and other	18.1	18.1	-	36.0	36.1	(0.1)

Interest expenses increased $0.3 million ($0.2 million year-to-date) primarily due to:

- $0.6 million ($1.1 million year-to-date) interest on the capital lease of our new corporate office building;

partially offset by:

- $0.2 million ($0.7 million year-to-date) interest rate support received through the Structured Financing Facility Program offered by the Government of Canada, reflecting amounts relating to the life extension of the *Quadra Queen II*; and
- $0.2 million ($0.3 million year-to-date) lower interest on the 12-year amortizing KfW loans. (See “Liquidity and Capital Resources” below for more detail.)

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.

Our ongoing capital expenditures are expected to be significantly lower than in the previous few years. Subject to changes that may result from the Commissioner's current review, over the next five years we expect our operational cash requirements will be met through operating cash flows and by accessing our credit facility from time to time. At September 30, 2011, our unrestricted cash and cash equivalents totalled $21 million and short-term investments totalled $59 million.

Receipt of $119.4 million of duty remission on our four foreign built vessels provides us with financial flexibility. As a result of this flexibility, in the three months ended September 30, 2011, we paid down $45 million in debt consisting of the principal amounts outstanding on the second tranche of the two 12-year, 4.98% loans with KfW.,These loan agreements were also amended to transfer the principal payments on these loans for the next three years to the second tranche, on which interest only is paid at a floating rate. The principal on these second tranches is due at maturity (March 2020 and June 2020).

Principal repayments due in the next five years are:

Year ended		
2012 (October – March)	$	10,875
2013		9,000
2014		149,000
2015		270,250
2016		24,000
Thereafter		851,875
	$	1,315,000

Over the next few years, we have two bond issues totalling $390 million that will mature ($140 million in December 2013 and $250 million in May 2014). We anticipate that at least one of these issues will be refinanced. We also monitor the current market for opportunities to ensure that our debt structure continues to be efficient.

We target maintaining a strong investment-grade credit rating to allow capital market access at reasonable interest rates. Our credit ratings at September 30, 2011, were A (DBRS) with a stable trend and A+ (Standard & Poor's) with a stable outlook.

Sources and 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 six months ended September 30, 2011 and 2010 are summarized in the table below:

Sources and uses of cash ($ millions)	**Three months ended September 30** 2011	2010	**Six months ended September 30** 2011	2010
Net earnings	57.3	54.3	51.8	55.2
Items not involving cash:				
Amortization	29.5	28.4	58.9	57.1
Other non-cash charges	0.9	1.4	1.8	1.8
Long-term regulatory costs deferred	(0.2)	(2.9)	(0.7)	(5.3)
Change in non-cash operating working capital	0.3	3.0	(18.3)	(8.3)
Cash provided by operating activities	87.8	84.2	93.5	100.5
Cash used by financing activities	(49.8)	(4.8)	(55.9)	(4.9)
Cash used in investing activities	(26.5)	(23.0)	(49.6)	(43.7)
Total increase (decrease) in cash and cash equivalents	11.5	56.4	(12.0)	51.9

Three Months Ended September 30, 2011

In the three months ended September 30, 2011, cash provided by operating activities included $0.2 million of cash used to reduce regulatory liabilities as follows:

- $5.1 million in fuel and interest costs deferred;

partially offset by:

- $4.3 million in fuel surcharges; and
- $0.6 million receivable from the Province relating to the Northern Routes.

Cash provided by operating activities also included a decrease in non-cash operating working capital of $0.3 million. This decrease in non-cash operating working capital was due to:

- $7.7 million decrease in prepaid expenses primarily due to $4.5 million in fuel, $1.2 million in property taxes, $0.8 million in service contracts, $0.6 million in insurance and $0.6 million in other miscellaneous items;
- $3.1 million increase in interest payable reflecting timing of interest and principal payments;
- $1.1 million decrease in accounts receivable, mainly due to receipt of a marine insurance no claims bonus and continuity credit; and
- $0.3 million increase in accrued employee costs.

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

- $6.7 million decrease in payables and accrued liabilities relating to refit and maintenance and other operating activities;
- $4.7 million decrease in deferred revenue mainly due to a decrease in reservations and assured loading tickets reflecting the seasonality of the business; and
- $0.5 million increase in materials inventory mainly due to an increase in materials for vessel refits reflecting the seasonality of the business.

Cash used in financing activities reflects the $45.0 million in principal loan prepayments of the Tranche B on the two 4.98% loans; $4.5 million in loan principal repayments on the 2.95% loan; and $0.3 million payment of capital lease obligations.

Cash used in investing activities consisted of:
- $27.8 million used to purchase capital assets (See “Investing in Our Capital Assets” below for detail of significant purchases);

partially offset by:
- $1.3 million reduction in debt service reserves.

Six Months Ended September 30, 2011

In the six months ended September 30, 2011, cash provided by operating activities included $0.7 million of cash used to reduce regulatory liabilities as follows:
- $8.6 million in fuel and interest costs deferred; and
- $0.1 million in performance term three submission costs;

partially offset by:
- $5.5 million in fuel surcharges;
- $1.5 million in other payments from the Province credited to deferred fuel accounts; and
- $1.0 million receivable from the Province relating to the Northern Routes.

Cash provided by operating activities also included an increase in non-cash operating working capital of $18.3 million. This increase in non-cash operating working capital was due to:
- $9.5 million decrease in payables and accrued liabilities relating to refit and maintenance and other operating activities;
- $4.4 million increase in accounts receivable, mainly due to $2.5 million increase in commercial travel cards receivable and $1.7 million in social program fees receivable reflecting the seasonality of the business;
- $2.5 million increase in prepaid expenses primarily due to $1.3 million in property taxes, $1.0 million in service contracts, and $0.7 million in insurance; partially offset by $0.1 million in fuel and $0.4 million in other miscellaneous items;
- $1.2 million decrease in deferred revenue, also reflecting the seasonality of the business;
- $1.1 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 March 31, 2011; and
- $0.9 million increase in inventory mainly due to an increase in materials for vessel refits reflecting the seasonality of the business.

The above items, which increased working capital, were partially offset by:
- $1.3 million increase in accrued employee costs.

Cash used in financing activities reflects a total of $51.4 million in long-term debt payments; $4.0 million repayment of short-term loans; and $0.5 million payment of capital lease obligations.

Cash used in investing activities consisted of:
- $55.7 million used to purchase capital assets (See “Investing in Our Capital Assets” below for detail of significant purchases); and
- $0.3 million used for finalization of long-term loan to the developer of our corporate office leased property;

partially offset by:
- $5.0 million in proceeds from short-term investments;
- $1.3 million reduction in debt service reserves; and
- $0.1 million proceeds from disposal of property, plant and equipment.

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.

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. 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. Final cost adjustments were made on April 15, 2011, bringing the total amount of the loan and the purchase option to $24.5 million.

The value of our capital assets was increased by $0.3 million in the three months ended June 30, 2011, to reflect the final cost adjustments.

Capital Expenditures

Capital expenditures in the three and six months ended September 30, 2011, totalled $31.1 million and $56.8 million, respectively:

Capital expenditures ($ millions)	**September 30, 2011**	
	3 Months	**6 Months**
Terminal marine structures	19.2	26.1
Vessel upgrades and modifications	4.7	15.4
Information technology	4.0	8.0
Terminal and building upgrades and equipment	3.2	7.3
Total capital expenditures	31.1	56.8

Terminal Marine Structures

Capital expenditures for terminal marine structures in the three and six months ending September 30, 2011, included the following:

Terminal marine structures ($ millions)		**September 30, 2011**	
Terminal	**Description**	**3 Months**	**6 Months**
Swartz Bay	Berth 4 and 5 replacement and refurbishment	4.6	7.8
Tsawwassen	Refurbishment of decks and berth 5 upgrades	6.4	7.1
Hornby Island	Replacement of ramp, wingwalls, towers & dolphins	4.6	5.0
Denman Island	Replacement of ramp, wingwalls, towers & dolphins	2.7	2.9
Tsawwassen	Major berth 4 replacement and refurbishment	0.4	1.1
Brentwood Bay	Modifications to accommodate the *Klitsa*	0.1	1.1
Various	Other projects	0.4	1.1
		19.2	26.1

The $19 million project at Swartz Bay for the upgrade of berths 4 and 5 includes replacement of ramps, ramp abutments, aprons, towers, wingwalls, dolphins and floating leads. Dredging at berth 5, ship-to-shore electrical upgrades and a new waiting shelter are also included. Completion of both berths is expected before the end of the fiscal year.

At Tsawwassen terminal, an $8 million project to replace the dolphins, catwalk and sheet pile wall at berth 5 is underway and a $2 million project for deck coating of two berths is nearing completion.

At Shingle Spit on Hornby Island and at Gravelley Bay on Denman Island, major marine structure replacement programs are underway. The combined $18 million multi-year projects include replacement of the wingwalls, ramps, ramp abutments, aprons, trestles, towers, and dolphins. Both projects are expected to be complete in November 2011.

Also at Tsawwassen terminal, the $32 million multi-year project for replacement and refurbishment of berth 4 is complete. The project replaced all 13 dolphins and the port wingwall. The lower ramp was replaced with a new multi-apron ramp with two-lane commercial vehicle capacity and the foundations and ramp supports were upgraded and a new hydraulic lift system installed.

At Brentwood Bay, modifications to marine structures were required to accommodate the *Klitsa* which replaced the 55-year-old *Mill Bay* sold in May 2011. This $2 million project included replacement of trestle, apron, port and starboard wingwalls, floating leads, two mooring dolphins, and construction of a small building for ticket collection and passenger shelter. Work began at the terminal on May 2, 2011, and service on this route resumed June 1, 2011.

Vessel Upgrades and Modifications

Capital expenditures for vessel upgrades and vessel modifications in the three and six months ended September 30, 2011, included the following:

Vessel upgrades and modifications ($ millions)	**September 30, 2011**	
	3 Months	**6 Months**
Queen of Chilliwack life extension	0.5	4.7
Sewage treatment upgrade program	2.5	5.3
Klitsa asset betterment	-	2.0
Powell River Queen passenger upgrades	0.5	0.5
Queen of Burnaby asset betterment	0.5	0.5
Electrical & navigational program	-	0.5
Other projects	0.7	1.9
	4.7	15.4

The project to extend the life of the 33-year-old *Queen of Chilliwack* began in December 2010, with the first phase of a two-phase project that will allow the vessel to continue in service until it is retired in 2017 or later. The vessel returned to service on June 14, 2011, following completion of the first phase of this $15 million project which included new car deck watertight doors, new propeller seals, new instrumentation and control systems, and new lifesaving systems. Ferry transportation fees for the Northern Routes will increase $1.8 million in fiscal 2012 as a result of 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 be 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. All vessels will be modified as part of this project or as part of their scheduled upgrade. Modification of the *Spirit of British Columbia*, *Skeena Queen, Kwuna, Queen of Nanaimo, Queen of Cumberland, Queen of Coquitlam, Queen of New Westminster, Quadra Queen II, Queen of Chilliwack, Queen of Capilano, North Island Princess,* and *Queen of Surrey* are complete.

The 39-year-old *Klitsa* returned to service on June 1, 2011, after completion of a $3 million asset betterment project. The betterment included new lifesaving systems, new right-angle drives and new sewage pump-ashore system.

Information Technology

Capital expenditures for information technology in the three and six months ending September 30, 2011, included the following:

Information technology

($ millions)	September 30, 2011	
	3 Months	**6 Months**
Customer service program	1.7	3.0
Bridge simulation training centres	1.3	1.4
Computer hardware upgrades	0.5	1.3
Operational document management system	0.2	0.6
Other projects	0.3	1.7
	4.0	8.0

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.

We have established bridge simulation training centres at three of our major terminals to enable the development and delivery of affordable, integrated and targeted bridge team training that reduces operational risk. The training program will leverage simulator best practices, minimize operational impacts and overhead, establish the infrastructure and lay the foundation for technical and team training for our bridge teams

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

An electronic document management system for the control, revision and publication of operations manuals is underway. This will enable employees access to current policy and procedure documents even when onboard a vessel.

Other projects include enhancements for improved supply chain management and a payroll system replacement initiative to replace both our payroll and labour distribution systems to provide added reliability and significant processing efficiencies and flexibility.

Terminal and Building Upgrades and Equipment
Capital expenditures for terminal and building upgrades and equipment in the three and six months ending September 30, 2011, included the following:

Terminal and building upgrades and equipment ($ millions)	**September 30, 2011**	
	3 Months	**6 Months**
Terminal waste water program	0.6	2.6
Vehicles, machinery & equipment	1.1	1.3
Horseshoe Bay overhead walkway	0.1	0.6
Security upgrades	0.4	0.4
Departure Bay terminal waiting room & restrooms	0.2	0.4
Swartz Bay roadway reconstruction	-	0.4
Other terminal projects	0.8	1.6
	3.2	7.3

As part of the multi-year sewage and waste water treatment program for treatment of sewage generated onboard our vessels, installation of pump ashore infrastructure at Bear Cove terminal is complete and in service and work at Langdale is underway. As part of the Federal government's Infrastructure Stimulus Fund program, we received $3.2 million in fiscal 2011 and estimate that we will receive a total of $8.8 million relating to sewage pump-ashore projects and other major terminal projects.

The costs incurred for vehicles, machinery, and equipment are primarily for upgrades to the electrical equipment at our maintenance facility and the purchase of a crane truck as well as electrical sub-metering at five of our terminals to take advantage of potential electricity conservation and reduction opportunities.

At Horseshoe Bay terminal, a $1.5 million project to improve safety with the installation of a new overhead walkway was completed in July 2011.

Our multi-year project to upgrade security at our terminals is expected to be complete before the end of the year. This project primarily involves fencing, gating, lighting, access controls and closed circuit television, as well as upgrades to foot passenger ticketing areas.

At Departure Bay terminal, a new waiting room and restrooms were completed in the second quarter.

At Swartz Bay terminal, reconstruction of the roadway at the vehicle entrance to the pick-up and drop-off areas was completed in the first quarter.

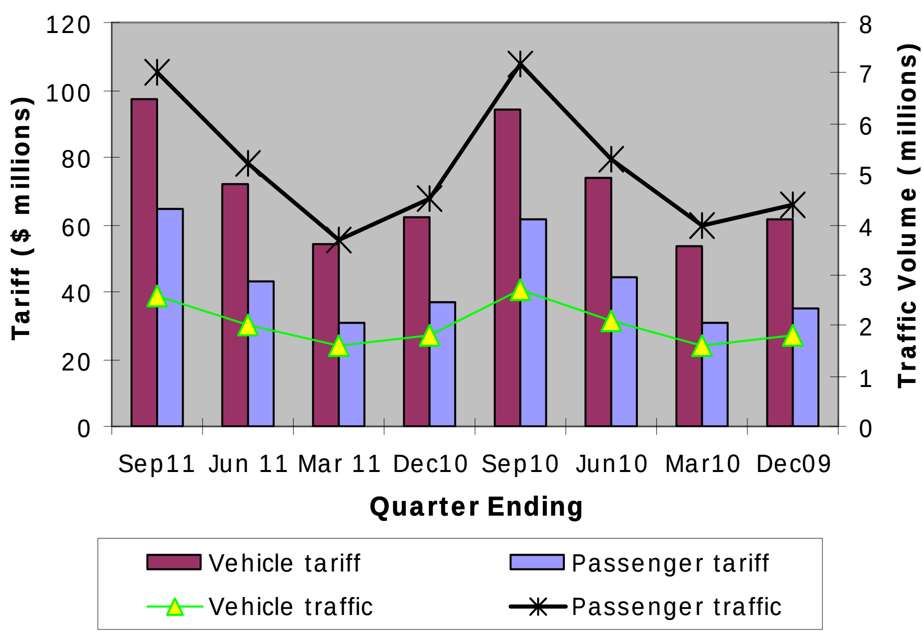
SUMMARY OF QUARTERLY RESULTS

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

($ millions)	Quarter Ended (unaudited)							
	Sep 11	**Jun 11**	**Mar 11**	**Dec 10**	**Sep 10**	**Jun 10**	**Mar 10**	**Dec 09**
Total revenue	252.1	186.7	140.7	162.4	246.0	190.2	142.3	159.9
Earnings (loss) from operations	75.4	12.4	(21.0)	(3.2)	72.4	18.9	(19.5)	(1.9)
Net earnings (loss) and comprehensive income	57.3	(5.5)	(39.0)	(12.4)	54.3	0.9	(36.8)	(20.4)

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 36 through 38 of our fiscal 2011 Management's Discussion & Analysis. Our risk profile is substantially unchanged during the six months ended September 30, 2011.

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 39 through 45 of our fiscal 2011 Management's Discussion & Analysis. Our risk profile is substantially unchanged during the six months ended September 30, 2011. An update on the risk relating to customer demand is included below.

We do not believe that material uncertainties exist in regards to our future. As part of our risk management strategies, 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.

Customer Demand

Our vehicle and passenger traffic levels in the six months ending September 30, 2011, as compared to the same period in the prior year, declined 3.4% and 2.9%, respectively. The decline in traffic was experienced across the Major, Northern and Other routes.

Impacting our traffic levels is the increased value of the Canadian dollar. More Canadians are travelling to the United States and fewer Americans are travelling to Canada. Many other factors affect customer demand, including current economic conditions, levels of tourism and discretionary travel. The cost of transportation, including the price of fuel at the pump and ferry fares (including the implementation and removal of fuel surcharges or rebates), disposable personal income, heightened global security and weather may have a negative effect on discretionary travel and levels of tourism.

We are uncertain as to the individual or cumulative impact these items may have on our revenues. No assurance can be given as to the level of traffic on our system and the resulting revenues.

Risk mitigation: We are constrained by the Coastal Ferry Services Contract which stipulates, among other things, the number of round trips that must be provided for each regulated ferry route. Within these constraints, we actively manage our capacity in an efficient and effective manner to ensure we can react quickly to changing levels of demand. Vessel planning strategies are in place and we regularly review and update our short and long-term financial and operating plans to ensure appropriate alignment of expenses with revenue.

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, 2011 and September 30, 2011 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 2011 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, 2011, or expect to use in the future.

Adoption of New Accounting Standards

No new accounting standards have been adopted for fiscal 2012.

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 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 1, 2012; and
  - Entities electing to defer the first-time adoption of IFRS 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 monitoring ongoing standards development as issued by the International Accounting Standards Board (IASB) 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 future balances of our regulatory accounts are uncertain, we cannot reasonably estimate and conclude the impact of IFRS on our 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 has also been completed, involved 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 the implementation and review phase.

  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 analyzed and recommendations made for key accounting policy decisions • IFRS 1 exemptions reviewed and analyzed • Senior management review of policy decisions complete • Preparation of illustrative financial statements and note disclosures complete • Senior management review of illustrative financial statements complete • Audit & Finance Committee review of illustrative financial statements complete • IFRS 1 exemptions finalized and quantified • Policies complete and procedures nearing completion

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 required to budgeting and forecasting processes complete

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 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 • Interdepartmental training on specific topics underway

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 • Review and update of process descriptions in progress • Policies complete 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 is substantially complete

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 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 their 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.

  The IASB closed its project on rate-regulated activities. However, the IASB has commenced consulting constituents to seek input on their strategic direction and preparation in setting work plans over the next three years. It has also provided constituents with suggestions for items to add to their agenda, including rate-regulated activities. We have provided a response in support of reinstating a project on rate-regulated activities.

  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, balances at March 31, 2011 of $3.7 million of current regulatory assets and $1.6 million of long-term regulatory liabilities will be derecognized on our transition date of April 1, 2011 with a net reduction in retained earnings of $2.1 million.

  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, identified, and quantified inspection and major overhaul items for each class of vessel for reclassification at transition date and internal reporting solutions are nearing completion.
    This change has the potential to cause significant fluctuations in earnings over the reporting periods due to the level of inspections and major overhauls in any one period and the number of periods over which each will be amortized.
  - *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 and the choices we have made will result in a net increase of $8.6 million in retained earnings on transition. The elections and 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. The actuarial loss to be recognized in opening retained earnings is $3.6 million.
    - *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.

- 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: economic conditions and traffic levels; annual assured loading revenue levels and the liability established for assured loading ticket refunds; a net loss in fiscal 2012 larger than $20 million; our future financial performance; the anticipated refinancing of at least one of the two bond issues maturing over the next few years; our short-term and long-range business plans, capital expenditure levels, and asset renewal programs for vessels and terminals; our expectations of ferry transportation fee amounts; our estimates of funding under the Infrastructure Stimulus Fund program; our expectations regarding how our operational cash requirements will be met; and our expectations regarding the impacts of Bill 14 and 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.