



***Management's Discussion &
Analysis
of Financial Condition and
Financial Performance***

For the three and nine months ended
December 31, 2018

Dated February 22, 2019

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**Management's Discussion & Analysis
of Financial Condition and Financial Performance
For the three and nine months ended December 31, 2018
Dated February 22, 2019**

The following is our discussion and analysis of the financial condition and financial performance for British Columbia Ferry Services Inc. ("BC Ferries") for the three and nine months ended December 31, 2018 that has been prepared with information available as of February 22, 2019. This discussion and analysis should be read in conjunction with our unaudited condensed interim financial statements and related notes for the nine month periods ended December 31, 2018 and 2017, and our audited consolidated financial statements and related notes for the years ended March 31, 2018 ("fiscal 2018") and March 31, 2017 ("fiscal 2017"), together with our Management's Discussion & Analysis for fiscal 2018. These documents are available on SEDAR at www.sedar.com and on our investor webpage at http://www.bcferrries.com/investors/financial_reports.html.

Except where indicated, all financial information herein is expressed in Canadian dollars and determined on the basis of International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board (the "IASB").

BUSINESS OVERVIEW

British Columbia Ferry Services Inc. is an independent company providing passenger and vehicle ferry services on the west coast of British Columbia. We operate one of the largest and most complex ferry systems in the world. In the three months ended December 31, 2018 (the third quarter of fiscal 2019), we provided transportation service with 35 vessels operating on 25 routes out of 47 terminals spread over 1,600 kilometres of coastline. 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.

Our Major Routes, which are our four busiest routes, consist of three regulated routes connecting Metro Vancouver with Vancouver Island and one regulated route connecting Horseshoe Bay and Langdale. In mid-September, we began service on a new Northern Route directly connecting Port Hardy and Bella Coola, bringing the total number of Northern Routes in operation to three. Our Other Routes consist of 18 regulated routes and 8 unregulated routes, primarily serving the northern and southern Gulf Islands and the northern Sunshine Coast.

During the three months ended December 31, 2018, we provided an average of 466 sailings per day for our customers. We delivered over 42,000 sailings, 157 more than in the same quarter in the prior year. We carried 4.7 million passengers and 2.0 million vehicles, an increase of 1.7% and 2.6%, respectively, compared to the same quarter in the prior year. In the nine months ended December 31, 2018, we carried 18.3 million passengers and 7.2 million vehicles, an increase of 1.2% and 2.0%, respectively, compared to the same period in the prior year. The passenger traffic levels experienced are the highest we have experienced in over 20 years and vehicle traffic levels were the highest we have ever experienced. For a discussion of our traffic levels, see "Financial and Operational Overview" below.

Significant events during or subsequent to the third quarter of fiscal 2019 include the following:

Vessels

- On October 5, 2018, we issued a Request for Expression of Interest (“RFEOI”) for the procurement of up to five new major vessels to replace aged fleet assets with the procurement process open to local, national and international shipyards. These new major vessels will reflect capacity and levels of service consistent with the current Coastal and Spirit Class vessels in size, capabilities and passenger amenities. These vessels are anticipated to begin service in 2023 on our Major Routes between Metro Vancouver and Vancouver Island which will allow for the retirement of the *Queen of Alberni*, *Queen of New Westminster*, *Queen of Cowichan* and *Queen of Coquitlam*. We also expect to introduce an additional vessel to the fleet to accommodate future traffic and build resiliency in the fleet. We expect to submit our application to the British Columbia Ferries Commissioner (the “Commissioner”) for approval of this major capital expenditure. Requests for proposals (each, an “RFP”) will be issued and, subject to a favourable decision by the Commissioner, we expect to award contracts in fiscal 2020.
- On January 7, 2019, the Commissioner approved our application of a major capital expenditure for one Salish Class vessel and four Island Class vessels. The procurement process includes two RFPs open to local, national and international shipyards. The first RFP issued in November 2018 is for the construction of one vessel, identical to our existing Salish Class vessels, with a capacity of 600 passengers and approximately 138 vehicles and an expected delivery date in 2021. The Salish Class vessel will be dual-fuel capable, running primarily on liquefied natural gas (“LNG”) using ultra-low sulphur marine diesel (“marine diesel”) as backup. The second RFP issued in December 2018 is for the construction of four 81-metre Island Class ferries, each with a capacity of up to 450 passengers and approximately 47 vehicles. The expected delivery date of the first two Island Class vessels is in 2020, with the following two ships expected to be delivered in 2021. The Island Class vessels will have hybrid diesel-electric propulsion and will be built to be capable of conversion to all-electric propulsion as the technology permits and the necessary infrastructure is put in place to support it. The five new vessels will allow for the retirement of the *Bowen Queen*, *Mayne Queen* and *Powell River Queen* and for the redeployment of certain other vessels around the fleet. We expect to complete the procurement process and award contracts in fiscal 2020.

General

- On January 25, 2019, the Commissioner issued Order 19-03, which supercedes Order 17-02, in which he re-established the criteria for determining a major capital expenditure which requires advance approval. The Commissioner’s orders are available on the Commissioner’s website at www.bcferrycommission.com.
- On February 22, 2019, the Province released its report which reviews the Coastal Ferry Services Contract (“CFSC”) and the provision of coastal ferry service in British Columbia.

FINANCIAL AND OPERATIONAL OVERVIEW

This section provides an overview of our financial and operational performance for the three and nine month periods ended December 31, 2018 and 2017.

| (\$millions) | Three months ended December 31 | | | Nine months ended December 31 | | |
|------------------------------------------|-----------------------------------|--------|----------|----------------------------------|-------|----------|
| | 2018 | 2017 | Variance | 2018 | 2017 | Variance |
| Total revenue | 207.7 | 195.7 | 12.0 | 753.2 | 731.8 | 21.4 |
| Operations | 122.8 | 118.0 | (4.8) | 401.3 | 377.6 | (23.7) |
| Maintenance | 22.4 | 28.2 | 5.8 | 60.3 | 62.7 | 2.4 |
| Administration | 9.6 | 9.1 | (0.5) | 29.3 | 28.3 | (1.0) |
| Depreciation and amortization | 43.5 | 40.4 | (3.1) | 128.5 | 119.1 | (9.4) |
| Operating expenses | 198.3 | 195.7 | (2.6) | 619.4 | 587.7 | (31.7) |
| Operating profit | 9.4 | - | 9.4 | 133.8 | 144.1 | (10.3) |
| Net finance and other | 13.1 | 14.8 | 1.7 | 40.6 | 43.2 | 2.6 |
| Net (loss) earnings | (3.7) | (14.8) | 11.1 | 93.2 | 100.9 | (7.7) |
| Other comprehensive (loss) income | (10.9) | 9.7 | (20.6) | (1.6) | 8.6 | (10.2) |
| Total comprehensive (loss) income | (14.6) | (5.1) | (9.5) | 91.6 | 109.5 | (17.9) |

Quarterly results are affected by the seasonality of leisure travel patterns. Our third quarter results reflect a seasonal reduction in traffic. We utilize this period to perform upgrades and major maintenance and refit programs, as well as to undertake mandatory inspections on the majority of our vessels.

Our net loss in the three months ended December 31, 2018 was \$11.1 million lower than the same period in the prior year. Year-to-date, net earnings are \$7.7 million lower than the same period in the prior year.

In the three months ended December 31, 2018, revenues increased by 6.1% (2.9% year-to-date) compared to the same period in the prior year, primarily as a result of increased traffic volumes, an increase in ferry transportation fees and the discontinuation of the fuel rebate, partially offset by a decrease in average tariffs. On April 1, 2018, we applied a fare reduction of 15% on the Northern Routes, the regulated Other Routes and on the Major Route connecting Horseshoe Bay and Langdale. Fares were held constant on the three Major Routes connecting Metro Vancouver with Vancouver Island. Also on April 1, 2018, the BC seniors' passenger discount increased from 50% to 100% for travel Monday to Thursday on the Major and Other Routes. The total estimated value of these initiatives over two years is approximately \$98 million, of which we will contribute \$39 million (\$16.7 million in fiscal 2019) in foregone revenue and the Province will contribute \$59 million (\$26.5 million in fiscal 2019). In the three months ended December 31, 2018, \$5.7 million (\$21.6 million year-to-date) received from the Province was recorded towards the fare reductions and the increase to the BC seniors' discount. (See "Revenue and Operational Statistics" for more detail.)

In the three months ended December 31, 2018, operating expenses increased by \$2.6 million or 1.3% (\$31.7 million or 5.4% year-to-date) compared to the same period in the prior year. The year-to-date expense increase included increases of \$9.4 million in depreciation, \$7.5 million due to higher wage rates and benefit costs, \$7.0 million due to higher fuel prices, \$3.0 million in one-time project-related costs and \$2.4 million in maintenance costs. The remainder of the increase

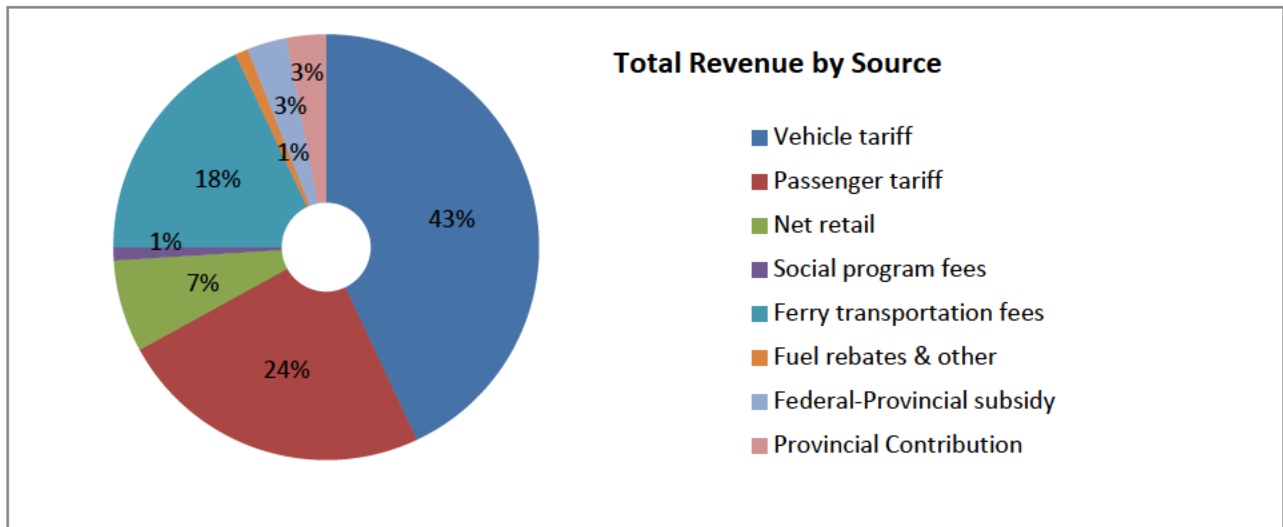
was primarily due to increases in labour, fuel consumption, and training-related costs to improve our customer experience and to accommodate the higher traffic volumes. In the nine months ended December 31, 2018, we provided 852.5 additional round trips throughout the system and adjusted the schedules for the routes operating out of Horseshoe Bay terminal. We also re-introduced the upgraded *Spirit of British Columbia* into service and implemented our new reservation system. (See "Expenses" for more detail.)

In the three months ended December 31, 2018, other comprehensive (loss) income was \$20.6 million lower than in the same period in the prior year. The \$10.9 million of other comprehensive loss in the three months ended December 31, 2018 and the \$9.7 million of other comprehensive income in the three months ended December 31, 2017 reflects the change in the fair value of our fuel swap contracts.

Year-to-date, other comprehensive (loss) income was \$10.2 million lower than in the same period in the prior year. The \$1.6 million of other comprehensive loss in the nine months ended December 31, 2018 reflects the change in the fair value of our fuel swap contracts. The \$8.6 million of other comprehensive income in the nine months ended December 31, 2017 reflects a \$10.5 million change in the fair value of our fuel swap contracts partially offset by a \$1.9 million loss on the actuarial valuation of our employee benefit plans.

Revenue and Operational Statistics

The following discussions of revenue are based on IFRS results, with reference to the impacts of rate regulation (See "Accounting Practices - The Effect of Rate Regulation"). Our Major Routes, which are our four busiest routes, consist of three regulated routes connecting Metro Vancouver with Vancouver Island and one regulated route connecting Horseshoe Bay and Langdale. Our Northern Routes consist of three regulated routes, including the new route connecting Port Hardy and Bella Coola, operating on the British Columbia coast north of Port Hardy on Vancouver Island. Our Other Routes consist of 18 regulated routes and 8 unregulated routes primarily serving the northern and southern Gulf Islands and the northern Sunshine Coast.



Select operational statistics and total revenues for the three and nine month periods ended December 31, 2018 compared to the same periods in the prior year are shown in the tables below.

| Operational Statistics | Three months ended December 31 | | Nine months ended December 31 | |
|--------------------------|-----------------------------------|-----------|----------------------------------|------------|
| | 2018 | 2017 | 2018 | 2017 |
| Vehicle traffic | 1,973,694 | 1,922,846 | 7,172,712 | 7,031,452 |
| Passenger traffic | 4,727,250 | 4,646,925 | 18,267,104 | 18,045,685 |
| On-time performance | 90.8% | 91.1% | 86.9% | 87.1% |
| Number of round trips | 19,511.5 | 19,299.0 | 61,073.5 | 60,221.0 |
| Capacity provided (AEQs) | 3,637,950 | 3,601,146 | 11,912,227 | 11,741,951 |
| AEQs carried | 2,243,156 | 2,184,669 | 8,121,312 | 7,956,950 |
| Capacity utilization | 61.7% | 60.7% | 68.2% | 67.8% |

In the three months ended December 31, 2018, vehicle traffic increased 2.6% (2.0% year-to-date) and passenger traffic increased 1.7% (1.2% year-to-date) compared to the same period in the prior year. We believe fare reductions and our vehicle fare pricing promotion had a positive impact on both passenger and vehicle traffic, partially offset by the impact of service disruptions.

On-time performance on the Major and regulated Other Routes is defined as the percentage of our sailings departing within 10 minutes of the scheduled time. On-time performance on the Northern Routes is defined as the percentage of our sailings arriving no later than 10 minutes after the scheduled time. In each case, on-time performance can be impacted by delays due to weather, vessel substitution, terminal dock maintenance or closures and periods of high traffic demand.

Meeting customer service expectations in a safe and reliable manner is the principal factor guiding our focus on on-time performance. Our initiatives to improve on-time performance include adjusting and/or expanding sailing schedules, adjusting crewing schedules and refining vehicle loading processes during peak periods. The Major Routes' on-time performance improved but was offset by a decrease on both the Northern and Other Routes primarily due to the impact of increased traffic demands. In the three months ended December 31, 2018, on-time performance decreased by 0.3% (0.2% year-to-date) compared to the same period in the prior year.

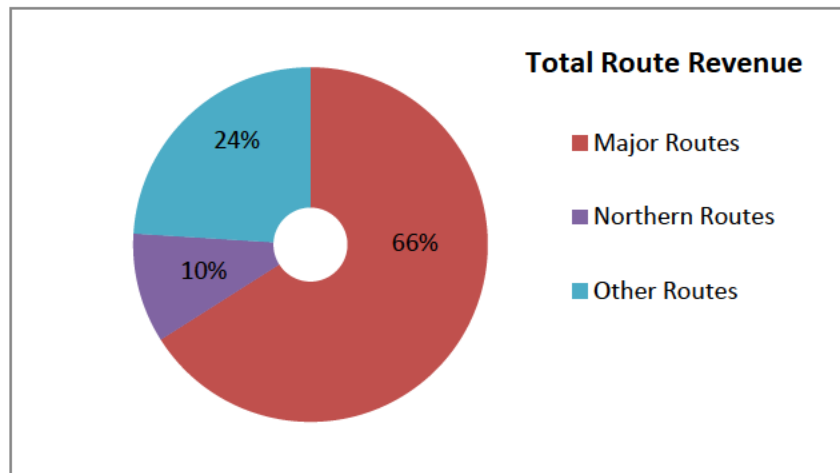
An automobile equivalent ("AEQ") is a standard unit of measure for an approximation of one car length. AEQs are calculated by using a conversion factor for each vehicle type. For example, a passenger vehicle would be one AEQ while a bus would be three AEQs. The change in AEQs from one period to the next may not be proportionate to the change in vehicle traffic, due to variations in the mix of vehicles types (the relative number of buses, commercial vehicles, and passenger vehicles), and actual size of vehicles carried.

Vehicle capacity provided, measured in AEQs, is the available vehicle deck space on a vessel multiplied by the number of sailings. The CFSC stipulates, among other things, the minimum number of round trips to be provided for each regulated ferry service route in exchange for ferry transportation fees. The number of round trips provided can be positively or negatively impacted by cancellations due to weather, vessel substitution, terminal dock closures and extra round trips made in response to high demand, or by changes to the number of round trips stipulated by the CFSC. In the three months ended December 31, 2018, we provided 212.5 (852.5 year-to-date) additional round trips compared to the same period in the prior year, resulting in an increase in capacity provided.

These statistics, shown in the table above, include the impact of schedule modifications required to accommodate the temporary removal of the *Queen of Cumberland* from service because of a mechanical failure. We applied for authorization to temporarily reduce service below the core services levels included in the CFSC for two ferry routes (Swartz Bay to the Southern Gulf Islands and Tsawwassen to the Southern Gulf Islands). The Commissioner approved our request and service was modified from April 18 through to May 18, 2018, when the *Queen of Cumberland* returned to regular service. We also applied to temporarily reduce service below the core service levels on the route connecting Thetis Island and Penelakut Island because of weather induced damages to the trestle and berth at Penelakut Island. The Commissioner approved our request and service was modified from December 20 through January 2.

Capacity utilization is calculated by dividing the AEQs carried during the period by the AEQ capacity provided on the vessels. Capacity utilization is impacted by the number of vehicles carried, the mix of vehicle types, the size of the vessels utilized and the number of round trips in each period. Capacity utilization increased to 61.7% from 60.7% for the three months ended December 31, 2018 compared to the same period in the prior year, as a result of a higher number of AEQs carried due to higher vehicle traffic levels, partially offset by an increase in capacity provided from additional round trips.

| Revenue (\$ millions) | Three months ended December 31 | | | Nine months ended December 31 | | |
|-----------------------------------|-----------------------------------|--------------|-------------|----------------------------------|--------------|--------------|
| | 2018 | 2017 | Increase | 2018 | 2017 | Increase |
| | | | (Decrease) | | | (Decrease) |
| Direct Route Revenue | | | | | | |
| Vehicle tariff | 87.9 | 86.6 | 1.3 | 321.2 | 324.9 | (3.7) |
| Passenger tariff | 46.2 | 49.6 | (3.4) | 184.5 | 199.7 | (15.2) |
| Fuel (rebates) surcharges | - | (4.2) | 4.2 | (4.6) | (15.8) | 11.2 |
| Net retail | 13.4 | 12.6 | 0.8 | 50.8 | 48.0 | 2.8 |
| Social program fees | 3.9 | 4.3 | (0.4) | 11.9 | 13.2 | (1.3) |
| Other revenue | 2.9 | 2.8 | 0.1 | 9.0 | 8.9 | 0.1 |
| Total Direct Route Revenue | 154.3 | 151.7 | 2.6 | 572.8 | 578.9 | (6.1) |
| Indirect Route Revenue | | | | | | |
| Ferry transportation fees | 40.0 | 36.1 | 3.9 | 134.4 | 128.7 | 5.7 |
| Federal-Provincial subsidy | 7.6 | 7.4 | 0.2 | 22.9 | 22.3 | 0.6 |
| Provincial contribution | 5.7 | - | 5.7 | 21.6 | - | 21.6 |
| Total Route Revenue | 207.6 | 195.2 | 12.4 | 751.7 | 729.9 | 21.8 |
| Other general revenue | 0.1 | 0.5 | (0.4) | 1.5 | 1.9 | (0.4) |
| Total Revenue | 207.7 | 195.7 | 12.0 | 753.2 | 731.8 | 21.4 |



In the nine months ended December 31, 2018, the greatest portion of our revenues (66%) was earned on our Major Routes. Revenue from the Northern Routes contributed 10% and revenue from Other Routes contributed 24%.

Vehicle tariffs (which include reservation fee revenue) and passenger tariffs account for the majority of our revenues. Our year to year tariff revenues are impacted by factors such as changes in overall traffic levels, traffic types, and tariff rates.

Net retail sales is our second largest source of direct revenue and provides a gross margin of approximately 60%, which contributes favourably to our net earnings and helps to keep fares affordable. Catering, retail and other on-board services are impacted by traffic levels, price, service quality, and product offerings.

On April 1, 2018, we applied a fare reduction of 15% on the Northern Routes, the regulated Other Routes, and on the Major Route connecting Horseshoe Bay and Langdale. Fares were held constant on the three Major Routes connecting Metro Vancouver with Vancouver Island. Also on April 1, 2018, the BC seniors' passenger discount increased from 50% to 100% for travel Monday to Thursday on the Major and Other Routes. The total estimated value of these initiatives over two years is approximately \$98 million, of which the Province will contribute \$59 million. In fiscal 2019, the Province will contribute a total of \$26.5 million, comprised of \$9.8 million for the increased BC seniors' discount and \$16.7 million towards fare reductions. In the three months ended December 31, 2018, \$5.7 million (\$21.6 million year-to-date) of the \$26.5 million was recorded as revenue. In the three months ended December 31, 2018, the number of BC seniors travelling with the discount increased 19.0% (19.6% year-to-date) compared to same period in the prior year.

Surcharges and/or rebates are implemented as a direct result of rising and declining fuel prices. A fuel rebate of 1.9% on the Northern Routes and 2.9% on our Major and regulated Other Routes was in place throughout fiscal 2018. These fuel rebates were discontinued on June 27, 2018 due to the rise in fuel prices. For the purpose of rate regulation, surcharges and/or rebates are applied to our deferred fuel cost accounts. (See "Accounting Practices - The Effect of Rate Regulation" for more detail.)

Year-to-year changes in operational statistics and revenue for the three and nine months ended December 31, 2018 and 2017 for the Major, Northern and Other Routes are discussed separately below.

Major Routes

Our Major Routes are our four busiest routes, carrying approximately 60% of our vehicle traffic and 65% of our passenger traffic, and generating approximately 83% of our total customer revenue, during the three and nine month periods ended December 31, 2018 and 2017.

| Operational Statistics | Three months ended December 31 | | Nine months ended December 31 | |
|--------------------------|-----------------------------------|-----------|----------------------------------|------------|
| | 2018 | 2017 | 2018 | 2017 |
| | Vehicle traffic | 1,143,324 | 1,129,240 | 4,242,315 |
| Passenger traffic | 3,012,425 | 2,992,711 | 11,794,238 | 11,773,037 |
| On-time performance | 87.8% | 80.3% | 82.2% | 79.5% |
| Number of round trips | 3,040.5 | 3,062.5 | 10,413.5 | 10,321.5 |
| Capacity provided (AEQs) | 1,893,360 | 1,903,553 | 6,485,668 | 6,436,949 |
| AEQs carried | 1,350,806 | 1,333,664 | 4,976,166 | 4,932,737 |
| Capacity utilization | 71.3% | 70.1% | 76.7% | 76.6% |

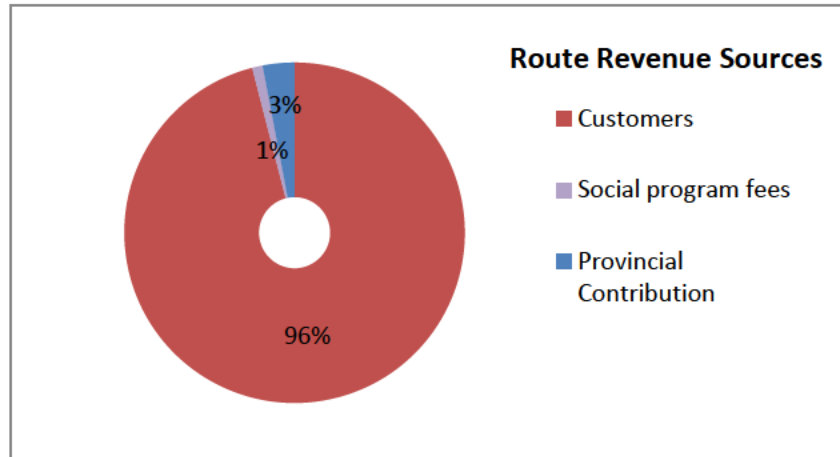
In the three months ended December 31, 2018, vehicle traffic increased 1.2% (0.8% year-to-date) and passenger traffic increased 0.7% (0.2% year-to-date) compared to the same period in the prior year. Over the three months ended December 31, 2018, severe storms impacted our traffic, although on average, weather conditions were better than in the same period in the prior year.

In the three months ended December 31, 2018, on-time performance increased significantly from 80.3% to 87.8%, with all of the Major Routes increasing with the exception of the route connecting Tsawwassen and Swartz Bay, which declined 0.5% compared to the same period in the prior year, primarily due to the increased vehicle traffic demands at peak times. Year-to-date, on-time performance on the Major Routes improved from 79.5% to 82.2% compared to the same period in the prior year.

Our initiatives to improve on-time performance at Horseshoe Bay terminal, where we have had challenges, included adjusting and/or expanding sailing schedules, adjusting crewing schedules, changing operational procedures and refining vehicle loading processes during peak periods. We expect to make further adjustments in the timing of scheduled service in our ongoing efforts to improve our service delivery and on-time performance.

Capacity utilization on these routes during the three months ended December 31, 2018 increased 1.2% (0.1% year-to-date) compared to the same period in the prior year, mainly as a result of a higher number of AEQs carried due to higher traffic levels and a decrease in capacity provided mainly due to a large number of round trips cancelled on a few stormy days. Year-to-date capacity utilization was on par with the same period in the prior year.

Major Routes cont'd



In the nine months ended December 31, 2018, revenue from our Major Routes consisted of 96% from customers and 4% from the Province (1% social program fees and 3% Provincial contributions).

| Revenue (\$ thousands) | Three months ended December 31 | | | Nine months ended December 31 | | |
|-----------------------------------|-----------------------------------|----------------|--------------|----------------------------------|----------------|---------------|
| | 2018 | 2017 | Increase | 2018 | 2017 | Increase |
| | | | (Decrease) | | | (Decrease) |
| Direct Route Revenue | | | | | | |
| Vehicle tariff | 75,789 | 73,439 | 2,350 | 273,672 | 271,894 | 1,778 |
| Passenger tariff | 39,034 | 41,084 | (2,050) | 152,823 | 161,076 | (8,253) |
| Fuel rebates | 1 | (3,404) | 3,405 | (3,758) | (12,756) | 8,998 |
| Net retail | 12,192 | 11,501 | 691 | 44,860 | 42,452 | 2,408 |
| Social program fees | 2,021 | 2,137 | (116) | 6,296 | 6,679 | (383) |
| Parking | 1,622 | 1,627 | (5) | 5,458 | 5,190 | 268 |
| Other revenue | 1,086 | 914 | 172 | 3,055 | 3,163 | (108) |
| Total Direct Route Revenue | 131,745 | 127,298 | 4,447 | 482,406 | 477,698 | 4,708 |
| Indirect Route Revenue | | | | | | |
| Provincial contribution | 3,488 | - | 3,488 | 12,645 | - | 12,645 |
| Total Route Revenue | 135,233 | 127,298 | 7,935 | 495,051 | 477,698 | 17,353 |

On April 1, 2018, we applied a fare reduction of 15% on our Major Route connecting Horseshoe Bay and Langdale. Fares were held constant on our three Major Routes connecting Metro Vancouver with Vancouver Island. Also on April 1, 2018, the BC seniors' passenger discount increased from 50% to 100% for travel Monday to Thursday on our Major Routes.

In the three months ended December 31, 2018, average tariff (tariff revenue divided by traffic volume) per vehicle increased \$1.25 or 1.9% compared to the same period in the prior year mainly as a result of increased reservations. Year-to-date, average tariff per vehicle decreased \$0.06 or 0.1% compared to the same period in the prior year, mainly due to the 15% reduction on our Major Route connecting Horseshoe Bay and Langdale. Passenger tariff revenue in the three months ended December 31, 2017 included \$1.4 million (\$4.8 million year-to-date) in revenue for BC seniors' passenger fares prior to implementing the 100% discount in fiscal 2019. In the three months ended December 31, 2018, average tariff per passenger decreased \$0.77 or 5.6% (\$0.72 or 5.3% year-to-date) compared to the same period in the prior year, primarily as a result of the increase in the BC seniors' discount, changes in the passenger mix and the 15% fare reduction on our Major Route connecting Horseshoe Bay and Langdale. In the three months ended December 31, 2018, the increase in traffic and the changes in average tariff resulted in a total tariff revenue increase of \$0.3 million compared to the same period in the prior year. Year-to-date, the decrease in average tariff partially offset by increased traffic, resulted in a total tariff revenue decrease of \$6.5 million compared to the same period in the prior year.

Major Routes cont'd

A fuel rebate of 2.9% on our Major Routes was in place throughout fiscal 2018. This fuel rebate was discontinued on June 27, 2018 (fiscal 2019), due to the rise in fuel prices.

All vessels that provide service on our Major Routes have a gift shop and options for food service. In the three months ended December 31, 2018, net retail sales increased 6.0% (5.7% year-to-date) compared to the same period in the prior year, primarily as a result of higher average sales per passenger. Food sales remain strong, providing approximately 72% of total retail revenue. Sales of quality apparel continue to grow and comprise over 10% of total retail revenue. Cost of goods sold is approximately 40% of total sales. The new coffee bar and the gift shop expansion on the *Spirit of British Columbia* contributed to the increase in net retail sales.

Social program fees are reimbursements from the Province of discounts provided on fares for students travelling to and from school, persons with disabilities and persons travelling under the Ministry of Health Travel Assistance Program ("MTAP"). Social program fees for the three months ended December 31, 2018 decreased 5.4% (5.7% year-to-date) compared to the same period in the prior year, mainly as a result of the 15% fare reduction and a decrease in the usage of the MTAP program

Revenue from parking in the three months ended December 31, 2018 was on par with the same period in the prior year. Year-to-date, revenue from parking increased 5.2% compared to the same period in the prior year, as a result of both an increase in parking rates and higher usage.

Other revenue increased in the three months ended December 31, 2018 compared to the prior year, mainly as a result of an increase in commissions received on the sale of books and magazines, however, year-to-date it remains 3.4% lower than the prior year.

The provincial contribution of \$3.5 million in the three months ended December 31, 2018 (\$12.6 million year-to-date) consisted of \$1.7 million (\$6.0 million year-to-date) towards the increased BC seniors' discount and \$1.8 million (\$6.7 million year-to-date) for fare initiatives (a fare reduction of 15% on the Horseshoe Bay – Langdale route and fares held constant on the other three Major Routes).

Northern Routes

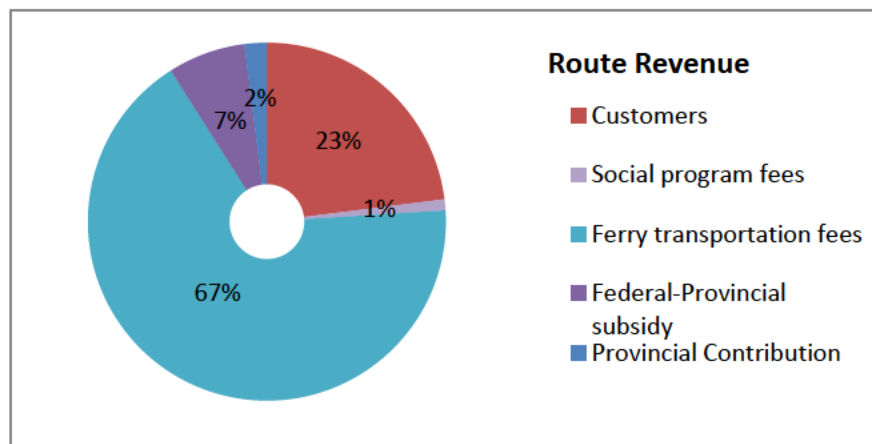
Until mid-September, our Northern Routes consisted of two regulated routes operating on the British Columbia coast north of Port Hardy on Vancouver Island. In September, we commenced a new seasonal direct ferry service connecting Port Hardy and Bella Coola.

| Operational Statistics | Three months ended | | Nine months ended | |
|--------------------------|--------------------|--------|-------------------|--------|
| | December 31 | | December 31 | |
| | 2018 | 2017 | 2018 | 2017 |
| Vehicle traffic | 5,755 | 5,178 | 28,995 | 27,788 |
| Passenger traffic | 13,388 | 12,094 | 79,176 | 78,320 |
| On-time performance | 85.2% | 87.0% | 84.7% | 88.7% |
| Number of round trips | 64.5 | 48.5 | 230.0 | 208.0 |
| Capacity provided (AEQs) | 12,289 | 12,079 | 48,489 | 47,408 |
| AEQs carried | 7,276 | 6,543 | 35,359 | 33,951 |
| Capacity utilization | 59.2% | 54.2% | 72.9% | 71.6% |

In the three months ended December 31, 2018, vehicle traffic increased 11.1% (4.3% year-to-date) and passenger traffic increased 10.7% (1.1% year-to-date) compared to the same period in the prior year, primarily as a result of the impact of fare reductions, the introduction of a new seasonal route, and fare pricing promotions.

On-time performance in the three months ended December 31, 2018 decreased 1.8% (4.0% year-to-date) over the same period in the prior year, primarily due to the increased vehicle traffic demands and delays due to weather.

Capacity utilization on these routes during the three months ended December 31, 2018 was 5.0% higher (1.3% year-to-date) than the same period in the prior year, primarily as a result of a higher number of AEQs carried, partially offset by increased capacity provided to service the new route.



In the nine months ended December 31, 2018, revenue from our Northern Routes consisted of 23% from customers and 77% from the Province (1% social program fees, 67% ferry transportation fees, 7% from payments under the Federal-Provincial subsidy agreement and 2% Provincial contribution).

Northern Routes cont'd

| Revenue (\$ thousands) | Three months ended December 31 | | | Nine months ended December 31 | | |
|-----------------------------------|-----------------------------------|---------------|--------------|----------------------------------|---------------|----------------|
| | 2018 | 2017 | Increase | 2018 | 2017 | Increase |
| | | | (Decrease) | | | (Decrease) |
| Direct Route Revenue | | | | | | |
| Vehicle tariff | 1,217 | 1,259 | (42) | 7,031 | 8,124 | (1,093) |
| Passenger tariff | 649 | 670 | (21) | 5,916 | 7,161 | (1,245) |
| Fuel rebates | - | (44) | 44 | (104) | (334) | 230 |
| Net retail | 182 | 141 | 41 | 1,415 | 1,373 | 42 |
| Social program fees | 257 | 225 | 32 | 843 | 877 | (34) |
| Stateroom rental | 339 | 309 | 30 | 1,495 | 1,406 | 89 |
| Hostling & other | 69 | 54 | 15 | 145 | 195 | (50) |
| Total Direct Route Revenue | 2,713 | 2,614 | 99 | 16,741 | 18,802 | (2,061) |
| Indirect Route Revenue | | | | | | |
| Ferry transportation fees | 14,550 | 10,735 | 3,815 | 54,190 | 49,174 | 5,016 |
| Federal-Provincial subsidy | 1,957 | 1,910 | 47 | 5,870 | 5,731 | 139 |
| Provincial contribution | 146 | - | 146 | 1,253 | - | 1,253 |
| Total Route Revenue | 19,366 | 15,259 | 4,107 | 78,054 | 73,707 | 4,347 |

In the three months ended December 31, 2018, average tariff (tariff revenue divided by traffic volume) per vehicle decreased 13.0% (17.1% year-to-date) and average tariff per passenger decreased 12.5% (18.3% year-to-date) compared to the same period in the prior year, mainly as a result of the 15% fare reduction introduced on April 1, 2018. Average tariffs also reflect a change in the proportion of traffic on routes with lower versus higher tariffs. The changes in traffic levels and decreases in average tariff during the three months ended December 31, 2018 resulted in a total tariff revenue decrease of \$0.1 million (\$2.3 million year-to-date) compared to the same period in the prior year.

A fuel rebate of 1.9% on the Northern Routes was in place throughout fiscal 2018. This fuel rebate was discontinued on June 27, 2018 (fiscal 2019) due to the rise in fuel prices.

Reimbursements from the Province for social program fees for the three months ended December 31, 2018 increased 14.2% compared to the same period in the prior year, mainly as a result of an increase in the usage of the MTAP program. Year-to-date, social program fees decreased 3.9% compared to the same period in the prior year, primarily as a result of the 15% fare reduction partially offset by an increase in the usage of the MTAP program.

Stateroom rental revenue increased due to higher utilization.

Ferry transportation fees received from the Province increased \$3.8 million in the three months ended December 31, 2018 (\$5.0 million year-to-date) compared to the same period in the prior year, mainly as a result of additional funding from the Province for the provision of additional services.

The Federal-Provincial subsidy increased by the change in the annual Consumer Price Index ("CPI") (Vancouver).

The provincial contribution of \$0.1 million in the three months ended December 31, 2018 (\$1.2 million year-to-date) consisted of a contribution towards the 15% fare reductions.

Other Routes

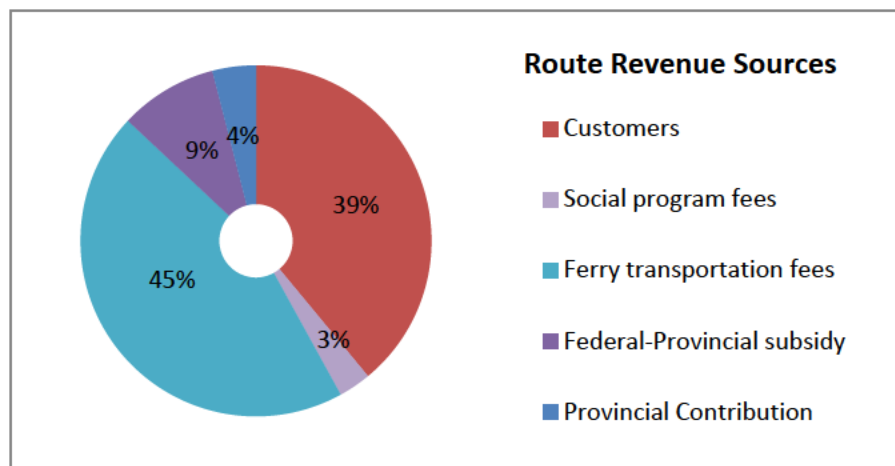
Our Other Routes primarily serve the northern and southern Gulf Islands and the northern Sunshine Coast. One of the 18 regulated routes and all eight of the unregulated routes are operated under contract by alternative service providers. We receive fees from the Province for the provision of contracted services on these routes, which are included in the ferry transportation fees in the table below. Unregulated routes are not incorporated in the following analysis.

| Operational Statistics | Three months ended | | Nine months ended | |
|--------------------------|--------------------|-----------|-------------------|-----------|
| | December 31 | | December 31 | |
| | 2018 | 2017 | 2018 | 2017 |
| Vehicle traffic | 824,615 | 788,428 | 2,901,402 | 2,793,075 |
| Passenger traffic | 1,701,437 | 1,642,120 | 6,393,690 | 6,194,328 |
| On-time performance | 91.3% | 92.9% | 87.8% | 88.5% |
| Number of round trips | 16,406.5 | 16,188.0 | 50,430.0 | 49,691.5 |
| Capacity provided (AEQs) | 1,732,301 | 1,685,514 | 5,378,070 | 5,257,594 |
| AEQs carried | 885,075 | 844,462 | 3,109,787 | 2,990,262 |
| Capacity utilization | 51.1% | 50.1% | 57.8% | 56.9% |

In the three months ended December 31, 2018, vehicle traffic increased 4.6% (3.9% year-to-date) and passenger traffic increased 3.6% (3.2% year-to-date) compared to the same period in the prior year. We believe fare reductions, the BC seniors' passenger discount increase and overall favourable weather conditions had a positive impact on both vehicle and passenger traffic.

On-time performance in the three months ended December 31, 2018 decreased 1.6% (0.7% year-to-date) over the same period in the prior year, primarily due to the increased vehicle traffic demands and delays due to stormy weather at peak times.

Capacity utilization on these routes during the three months ended December 31, 2018 was 1.0% higher (0.9% year-to-date) compared to the same period in the prior year, primarily due to a higher number of AEQs carried, partially offset by an increase in capacity provided.



In the nine months ended December 31, 2018, revenue from our Other Routes consisted of 39% from customers and 61% from the Province (3% social program fees, 45% ferry transportation fees, 9% from payments under the Federal-Provincial subsidy agreement, and 4% Provincial contribution).

Other Routes cont'd

| Revenue (\$ thousands) | Three months ended December 31 | | | Nine months ended December 31 | | |
|-----------------------------------|-----------------------------------|---------------|----------------|----------------------------------|----------------|----------------|
| | 2018 | 2017 | Increase | 2018 | 2017 | Increase |
| | | | (Decrease) | | | (Decrease) |
| Direct Route Revenue | | | | | | |
| Vehicle tariff | 10,852 | 11,899 | (1,047) | 40,469 | 44,921 | (4,452) |
| Passenger tariff | 6,479 | 7,850 | (1,371) | 25,723 | 31,451 | (5,728) |
| Fuel rebates | - | (720) | 720 | (722) | (2,692) | 1,970 |
| Social program fees | 1,672 | 1,909 | (237) | 4,839 | 5,653 | (814) |
| Net retail | 777 | 669 | 108 | 3,102 | 2,776 | 326 |
| Parking & other | 104 | 86 | 18 | 302 | 302 | - |
| Total Direct Route Revenue | 19,884 | 21,693 | (1,809) | 73,713 | 82,411 | (8,698) |
| Indirect Route Revenue | | | | | | |
| Ferry transportation fees | 25,365 | 25,374 | (9) | 80,162 | 79,491 | 671 |
| Federal-Provincial subsidy | 5,669 | 5,536 | 133 | 17,008 | 16,606 | 402 |
| Provincial contribution | 2,054 | - | 2,054 | 7,706 | - | 7,706 |
| Total Route Revenue | 52,972 | 52,603 | 369 | 178,589 | 178,508 | 81 |

On April 1, 2018, we introduced a fare reduction of 15% on our Other Routes. Also on April 1, 2018, the BC seniors' passenger discount increased from 50% to 100% for travel Monday to Thursday on these routes.

In the three months ended December 31, 2018, average tariff per vehicle (tariff revenue divided by traffic volume) decreased 12.8% (13.3% year-to-date), reflecting the fare reduction, partially offset by an increase in the proportion of traffic on routes with higher versus lower tariffs. In the three months ended December 31, 2018, average tariff per passenger decreased 20.4% (20.8% year-to-date), mainly reflecting the fare reduction of 15% and increased BC seniors' passenger discount implemented at April 1, 2018 on our Other Routes. Passenger tariff revenue in the three months ended December 31, 2017 included \$0.6 million (\$2.2 million year-to-date) in revenue for BC seniors' passenger fares prior to implementing the 100% discount in fiscal 2019. The decrease in average tariff, partially offset by the increase in traffic levels resulted in a total tariff revenue decrease of \$2.4 million (\$10.2 million year-to-date) compared to the same period in the prior year.

A fuel rebate of 2.9% on our Other Routes was in place throughout fiscal 2018. This fuel rebate was discontinued on June 27, 2018 (fiscal 2019), due to the rise in fuel prices.

Social program fees for the three months ended December 31, 2018 decreased 12.4% (14.4% year-to-date) compared to the same period in the prior year, mainly as a result of the 15% fare reduction and a decrease in the usage of the MTAP program.

Net retail services revenue increased in the three and nine months ended December 31, 2018 compared to the same period in the prior year as a result of both higher passenger traffic and higher average sales per passenger.

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

The provincial contribution of \$2.1 million in the three months ended December 31, 2018 (\$7.7 million year-to-date) consisted of \$0.6 million (\$2.0 million year-to-date) towards the increased BC seniors' discount and \$1.5 million (\$5.7 million year-to-date) for fare reductions.

Expenses

Expenses for the three and nine month periods ended December 31, 2018 and 2017 are summarized in the table below:

| Operating expenses (\$ millions) | Three months ended December 31 | | | Nine months ended December 31 | | |
|---------------------------------------------------------------|-----------------------------------|--------------|--------------|----------------------------------|--------------|-------------|
| | 2018 | 2017 | Increase | 2018 | 2017 | Increase |
| | | | (Decrease) | | | (Decrease) |
| Operations | 122.8 | 118.0 | 4.8 | 401.3 | 377.6 | 23.7 |
| Maintenance | 22.4 | 28.2 | (5.8) | 60.3 | 62.7 | (2.4) |
| Administration | 9.6 | 9.1 | 0.5 | 29.3 | 28.3 | 1.0 |
| Total operations, maintenance & administration | 154.8 | 155.3 | (0.5) | 490.9 | 468.6 | 22.3 |
| Depreciation and amortization | 43.5 | 40.4 | 3.1 | 128.5 | 119.1 | 9.4 |
| Total operating expenses | 198.3 | 195.7 | 2.6 | 619.4 | 587.7 | 31.7 |

To improve our customer experience and to accommodate higher traffic volumes, we provided 212.5 (852.5 year-to-date) additional round trips throughout the system compared to the same period in the prior year and adjusted the schedule for the routes operating out of Horseshoe Bay terminal. We also re-introduced the upgraded *Spirit of British Columbia* into service and implemented our new reservation system. Together, these actions resulted in an increase in labour, fuel consumption, and training-related costs partially offset by the lower cost reflecting the *Spirit of British Columbia's* consumption of LNG rather than marine diesel. The increase in operating expense also included the impact of higher marine diesel prices, wage rate increases in accordance with the Collective Agreement with the BC Ferry & Marine Workers' Union and higher depreciation. We continue to take proactive measures to contain and manage expenses while operating a sustainable, safe and reliable service.

In the three months ended December 31, 2018, operations expenses increased \$4.8 million compared to the same period in the prior year due to:

- \$3.4 million increase in wages and benefits costs, mainly due to staffing level changes for the additional service provided and wage rate increases;
- \$2.2 million increase in fuel expense, reflecting higher marine diesel prices, somewhat offset by lower LNG prices;
- partially offset by:
- \$0.3 million decrease in other costs including materials and supplies; and
- \$0.5 million decrease in contracted services.

Year-to-date, operations expenses increased \$23.7 million compared to the same period in the prior year due to:

- \$15.4 million increase in wages and benefits costs, mainly due to staffing level changes for the additional service provided, wage rate increases, an increase in overtime, and an increase in hours spent on training activities;
- \$7.0 million increase in fuel expense, reflecting a 1.5% or \$1.2 million increase in fuel consumption primarily as a result of additional round trips provided and a 7.2% or \$5.8 million increase due to higher marine diesel prices, somewhat offset by lower LNG prices;
- \$2.4 million increase in contracted services mainly related to projects including the *Spirit of British Columbia* re-entering service;
- \$0.5 million increase in other costs including training related costs, software licences, network costs and materials and supplies;
- partially offset by:

- \$1.6 million decrease primarily due to an emergency drydocking in the prior year of the *Spirit of Vancouver Island*.

The \$5.8 million (\$2.4 million year-to-date) decrease in maintenance costs compared to the prior year is primarily as a result of the cyclical nature of vessel refit activity.

The \$0.5 million (\$1.0 million year-to-date) increase in administration costs compared to the prior year is primarily as a result of contracted services for information technology including equipment maintenance.

Depreciation and amortization increased \$3.1 million (\$9.4 million year-to-date), reflecting new capital assets that have entered service. (See "Investing in our Capital Assets" below for details of capital asset expenditures.)

| Net finance and other expenses (\$ millions) | Three months ended December 31 | | | Nine months ended December 31 | | |
|----------------------------------------------------------------------------------------------------------|-----------------------------------|-------|------------|----------------------------------|-------|------------|
| | 2018 | 2017 | Increase | 2018 | 2017 | Increase |
| | | | (Decrease) | | | (Decrease) |
| Finance expense | 14.7 | 15.3 | (0.6) | 45.0 | 45.9 | (0.9) |
| Less: finance income | (1.7) | (1.5) | (0.2) | (4.6) | (3.9) | (0.7) |
| Net finance expense | 13.0 | 13.8 | (0.8) | 40.4 | 42.0 | (1.6) |
| Loss on disposal and revaluation of property, plant and equipment, intangible assets and inventory | 0.1 | 1.0 | (0.9) | 0.2 | 1.2 | (1.0) |
| Total net finance and other expenses | 13.1 | 14.8 | (1.7) | 40.6 | 43.2 | (2.6) |

In the three months ended December 31, 2018, net finance and other expenses decreased \$1.7 million (\$2.6 million year-to-date) compared to the same period in the prior year mainly due to:

- \$0.2 million (\$0.7 million year-to-date) increase in interest income on investments;
- \$0.3 million (\$0.7 million year-to-date) decrease in interest on KfW IPEX-Bank GmbH ("KfW") loans, reflecting \$6.6 million (\$24.2 million year-to-date) in principal repayments; and
- \$0.9 million (\$1.0 million year-to-date) decrease as result of a higher loss on disposal of assets in the prior year.

LIQUIDITY AND CAPITAL RESOURCES

Liquidity and Capital Resources

We fund our operations and capital acquisitions with cash flow generated from operations, as well as bank financing and debt issues.

We expect our cash requirements, in the near term, will be met through operating cash flows, funding under government programs and by accessing our credit facility from time to time. At December 31, 2018, our unrestricted cash and cash equivalents and other short-term investments totalled \$110 million and \$90 million, respectively (at March 31, 2018 - \$70 million and \$114 million, respectively).

On March 21, 2017, the Government of Canada approved funding of up to \$15.1 million under the New Building Canada Fund towards the new seasonal direct ferry service between Port Hardy and Bella Coola. In addition to the \$15.1 million, in fiscal 2017, the Government of Canada also approved funding of up to \$45.4 million under the New Building Canada Fund towards the purchase of two new Island Class vessels currently under construction and a major upgrade of our Langdale terminal. In total, up to \$60.5 million in funding under the New Building Canada Fund has been approved, of which \$15.9 million was received by December 31, 2018.

Our \$155 million credit facility with a syndicate of Canadian banks was renewed on March 19, 2018 to extend the maturity date of the facility from April 2022 to April 2023. The facility is available to fund capital expenditures and for other general corporate purposes. At December 31, 2018, there were no draws on this credit facility.

We target maintaining a strong investment-grade credit rating to allow capital market access at reasonable interest rates. On December 6, 2018, Standard & Poor's reaffirmed our credit rating at "AA-" with a positive outlook and on January 17, 2019 DBRS reaffirmed our credit rating at "A (high)" with a stable trend.

Our debt service coverage (earnings before interest, taxes, depreciation, amortization, and rent) is required to be at least 1.25 times the debt service cost under the credit agreement. Our Master Trust Indenture has an additional indebtedness test that disallows additional borrowing if our leverage ratio exceeds 85%. At December 31, 2018, we achieved a debt service coverage ratio of 2.80 and a leverage ratio of 69.0%.

Sources & Uses of Cash

Sources and uses of cash and cash equivalents for the nine month periods ended December 31, 2018 and 2017 are summarized in the table below:

| (\$ millions) | Nine months ended December 31 | | |
|-------------------------------------------------------|-------------------------------|--------------|------------------------|
| | 2018 | 2017 | Increase (Decrease) |
| Cash and cash equivalents, beginning of period | 69.9 | 72.0 | (2.1) |
| Cash from operating activities: | | | |
| Net earnings | 93.2 | 100.9 | (7.7) |
| Items not affecting cash | 170.9 | 166.5 | 4.4 |
| Changes in non-cash operating working capital | (7.5) | 7.8 | (15.3) |
| Net interest paid | (46.8) | (47.8) | 1.0 |
| Cash generated by operating activities | 209.8 | 227.4 | (17.6) |
| Cash (used in) generated by financing activities | (25.8) | 18.4 | (44.2) |
| Cash used in investing activities | (144.3) | (212.6) | 68.3 |
| Net increase in cash and cash equivalents | 39.7 | 33.2 | 6.5 |
| Cash and cash equivalents, end of period | 109.6 | 105.2 | 4.4 |

For the nine months ended December 31, 2018, cash generated by operating activities decreased \$17.6 million compared to the prior year, primarily due to a decrease in net earnings, changes in working capital (receivables, prepaids, payables and deferred revenue) partially offset by items not affecting cash. Net earnings reflect the impact of higher operating expenses partially offset by increased traffic levels, higher revenues and lower finance expenses.

Cash used in financing activities in the nine months ended December 31, 2018 was \$25.8 million. This amount consisted of \$24.2 million repayment of KfW loans and \$1.6 million in repayment of finance lease obligations.

Cash generated by financing activities in the nine months ended December 31, 2017 was \$18.4 million. This amount consisted of an additional \$45.3 million loan from KfW IPEX-Bank GmbH, partially offset by \$25.5 million in repayment of KfW loans and finance lease obligations and \$1.4 million in deferred financing costs.

Cash used in investing activities in the nine months ended December 31, 2018 decreased by \$68.3 million compared to the prior year, mainly due to an \$16.5 million decrease in cash used for capital expenditures, a \$51.3 million decrease in cash used for short-term investing, and a \$0.5 million change in debt service reserves. (See "Investing in Our Capital Assets" below for detail of significant capital expenditures.)

SUMMARY OF QUARTERLY RESULTS

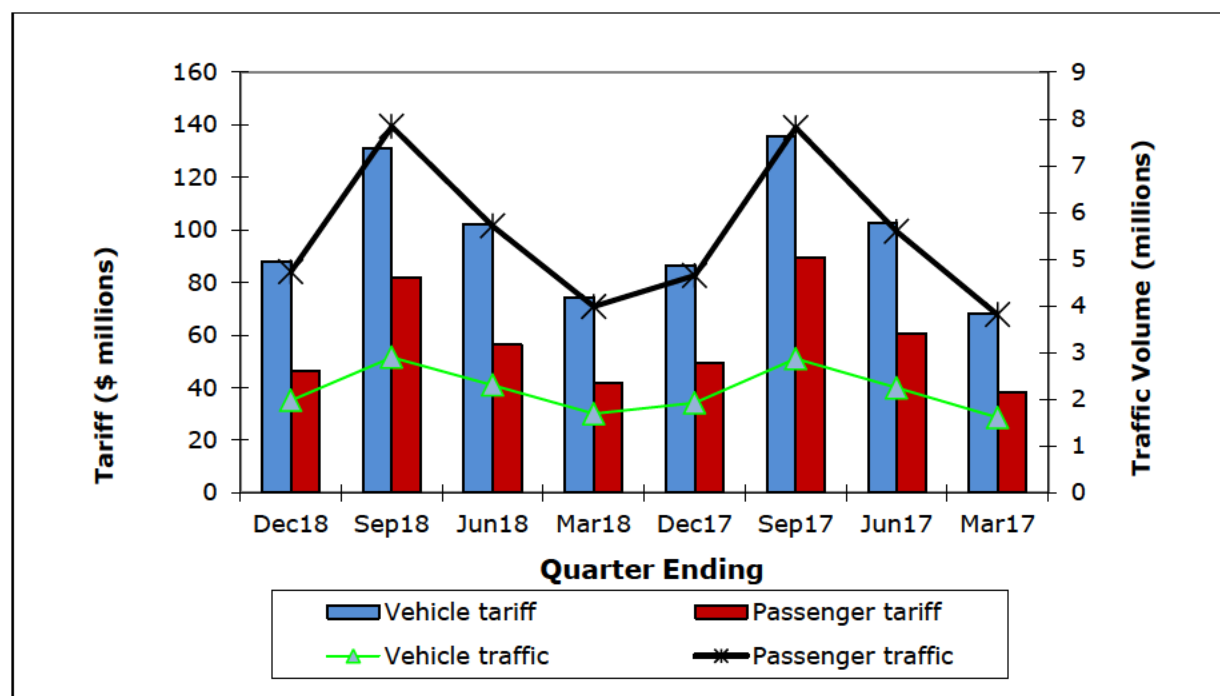
The table below compares earnings and comprehensive income by quarter for the most recent eight quarters:

| (\$ millions) | Quarter Ended (unaudited) | | | | | | | |
|-------------------------|---------------------------|--------|--------|--------|--------|--------|--------|--------|
| | Dec 18 | Sep 18 | Jun 18 | Mar 18 | Dec 17 | Sep 17 | Jun 17 | Mar 17 |
| Total revenue * | 207.7 | 315.8 | 229.7 | 168.7 | 195.7 | 309.9 | 226.2 | 157.9 |
| Operating profit (loss) | 9.4 | 104.6 | 19.8 | (27.8) | - | 112.6 | 31.5 | (25.8) |
| Net (loss) earnings | (3.7) | 90.9 | 6.0 | (41.0) | (14.8) | 98.4 | 17.3 | (40.8) |

*Previous quarters have been restated for consistency to reflect gross parking revenues, rather than net of parking expenses.

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.

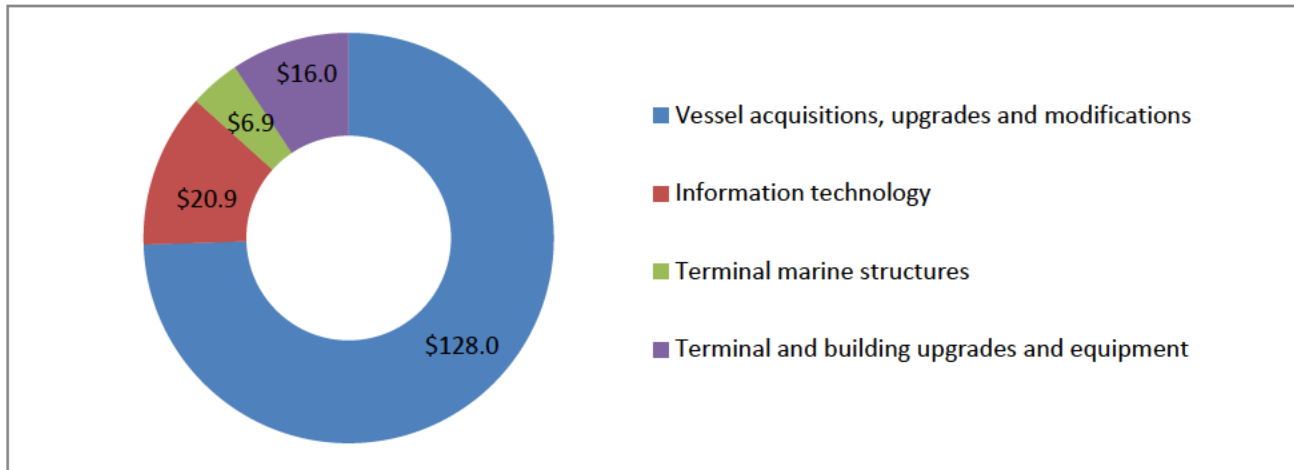
The following graph demonstrates the seasonality of our revenue and shows the relationship of traffic volume and tariff revenue over the most recent eight quarters:



INVESTING IN OUR CAPITAL ASSETS

Capital Expenditures

Capital expenditures, net of funding from the New Building Canada Fund and FortisBC, in the nine months ended December 31, 2018 totalled \$171.8 million.



In total, we have been approved for up to \$60.5 million in funding under the New Building Canada Fund, consisting of \$15.1 million for the *Northern Sea Wolf* project, \$28.3 million for the new Island Class vessel project and \$17.1 million for the Langdale terminal development project.

FortisBC has committed to provide us with up to \$16 million in incentive funding to help offset incremental capital costs associated with LNG for the Spirit Class and the Salish Class vessels. The contribution is dependent upon the purchase of LNG and is applied to the capital costs as LNG is purchased. In the three months ended December 31, 2018, \$0.3 million was recorded to reduce the capital costs of the Spirit Class vessels and \$0.5 million to reduce the capital costs of the Salish Class vessels.

Capital expenditures, net of funding from the New Building Canada Fund and FortisBC, in the three and nine month periods ended December 31, 2018, included the following:

| (\$ millions) | December 31, 2018 | |
|------------------------------------|-------------------|--------------|
| | 3 months | 9 months |
| Spirit Class mid-life upgrades | 6.2 | 45.9 |
| Major overhauls and inspections | 19.9 | 37.6 |
| Mid-coast ferry service | - | 24.6 |
| Island Class vessels | 0.6 | 15.9 |
| Customer experience program | 2.8 | 9.1 |
| Hardware upgrades | 4.9 | 8.4 |
| Fleet maintenance facility | 1.4 | 5.3 |
| Tsawwassen-shoreline stabilization | 0.2 | 3.0 |
| <i>Kuper</i> quarter-life upgrade | 2.1 | 2.3 |
| Departure Bay-holding compound | - | 1.6 |
| Bear Cove-replace floating leads | 0.9 | 1.0 |
| Various other projects | 6.0 | 17.1 |
| | 45.0 | 171.8 |

Spirit Class mid-life upgrades

In March 2016, we awarded contracts to Remontowa Ship Repair Yard S.A. to conduct the mid-life upgrades, including major upgrades to customer amenities, and conversion to dual-fuel, of our two largest vessels, the *Spirit of Vancouver Island* and the *Spirit of British Columbia*. We included \$30 million in the original project budget to cover import duty for when the Spirit Class vessels re-enter Canada. On October 31, 2018, we received a ruling from the Canada Border Services Agency confirming that entry would be duty free. On June 6, 2018, the *Spirit of British Columbia* returned to service, after undergoing its mid-life upgrade. On October 15, 2018, the *Spirit of Vancouver Island* arrived in Gdansk, Poland for its mid-life upgrade. The mid-life upgrades will enable the vessels to be in service for another 25 years. The *Spirit of Vancouver Island* is expected to return to service in the first quarter of fiscal 2020. We expect the conversion of these vessels to result in substantial savings, as LNG costs are considerably less than ultra-low sulphur marine diesel. We also expect the conversion to result in significant environmental benefits, such as reducing carbon, sulphur and nitrogen dioxide emissions from our vessels. FortisBC has committed to provide us with up to \$10 million in incentive funding to help offset incremental capital costs associated with the conversion of the Spirit Class vessels to use LNG. The contribution (\$4.4 million has been received by December 31, 2018) is dependent upon the purchase of at least 10 million gigajoules of LNG over a 10-year period and will be applied to the capital costs as LNG is purchased. In the three months ended December 31, 2018, \$0.3 million was recorded to reduce the capital costs.

Major overhauls and inspections

In the three months ended December 31, 2018, we had capital expenditures of \$19.9 million (\$37.6 million year-to-date) in respect of major overhauls and inspections of components of hull, propulsion and generators for seven vessels that were completed or underway.

Mid-coast ferry service

On April 7, 2017, we finalized an agreement to acquire a 75-metre used vessel to provide a new seasonal direct ferry service between Port Hardy and Bella Coola. This project includes the acquisition and upgrading of a used vessel as well as modifying our terminal marine structures as necessary. On April 5, 2017, the Province contributed an initial \$15 million towards the provision of this service for the period up to March 31, 2020. On March 21, 2017, the Government of Canada approved funding of up to \$15.1 million from the New Building Canada Fund, of which we recorded \$11.8 million in fiscal 2018 and \$3.3 million in the nine months ended December 31, 2018. On December 15, 2017, the *Northern Sea Wolf* arrived in British Columbia after a 10,097 nautical mile journey from Athens, Greece. The vessel is undergoing extensive upgrades necessary to bring it up to our and Transport Canada's standards of safety and reliability and will enter service in the spring of 2019. The *Northern Sea Wolf*, built in 2000, will accommodate approximately 35 vehicles and 150 passenger and crew.

Island Class vessels

On April 13, 2017, we entered into design and build contracts with Damen Shipyard Group of Netherlands for the construction of two Island Class vessels. The Government of Canada has approved funding of up to \$28.3 million under the New Building Canada Fund toward these vessels, of which we recorded \$3.1 million in fiscal 2018 and \$7.2 million in the nine months ended December 31, 2018. These vessels will each have a capacity of up to 450 passengers and crew and approximately 47 vehicles. Both vessels are to be launched in February 2019, with provisional delivery in Romania, for the first vessel anticipated in June and for the second in August. When these new vessels are placed into service in early 2020, it will allow us to retire the 60-year old *North Island Princess* and the 54-year old *Howe Sound Queen*. We intend to deploy the first new vessel to provide service between Powell River and Texada Island and the second new vessel to provide service between Port McNeill, Alert Bay and Sointula, early in 2020.

Hardware upgrades

Hardware upgrades include the replacement of aged computers, servers, printers, routers, closed-circuit cameras, antennas, digital signage and handheld units for inventory management.

Customer experience program

Our customer experience program, which includes the Fare Flexibility and Digital Experience Initiative, will replace our aged website, reservation system and e-commerce platform and upgrade our point-of-sale. The main elements will be implemented in stages during fiscal 2020. This program will give customers an opportunity to purchase travel in advance at discounted rates on select sailings on reservable routes and will allow us to respond in a more timely fashion to changing business needs and to better support marketing, travel services and pricing initiatives. Our customer experience program will introduce improved transaction processing and online booking with more choices in fares. We have implemented our new reservations system as well as enhancements to our customer relationship management system and point of sale system.

Fleet maintenance facility

At Richmond, a project to redevelop and modernize our ship repair and maintenance facility is in the design and development stage. It is expected that an application for this capital expenditure will be submitted to the Commissioner in fiscal 2020.

Tsawwassen terminal

At Tsawwassen, a project to prevent shoreline erosion and increase stability and drainage on both sides of the causeway completed in September 2018.

Kuper quarter-life upgrade

A \$2.9 million project for the quarter-life upgrade of the *Kuper* including, a wheelhouse expansion, bridge equipment upgrades, interior modernization and replacement of electrical and mechanical components was completed in December 2018.

OUTLOOK

We continue to pursue strategies to create an affordable, sustainable and safe ferry system that meets the needs of our customers and the communities we serve. We are committed to being a company worthy of the public's trust and valued for the services we provide.

Major Investments

Our 12-year capital plan for fiscal 2019 through fiscal 2030 is \$3.9 billion. This plan addresses the need to replace our aged assets. It includes 17 new vessels and significant upgrades to our terminals and our fleet maintenance facility. The plan emphasizes system capacity, operational efficiency, resiliency and flexibility to ensure safe, reliable and efficient operations and to deliver an exceptional customer-focused travel experience. In fiscal 2019, our capital spending is projected to be \$309 million and includes the second of two mid-life upgrades on the Spirit Class vessels, other ongoing vessel replacement projects, and the upgrade of the *Northern Sea Wolf* and modifications to minor terminals for the new seasonal ferry service between Port Hardy and Bella Coola.

Our three new Salish Class vessels, brought into service in fiscal 2018, are dual-fuel capable, running primarily on LNG using marine diesel as backup. The vessel design is part of our standardization strategy which we believe strengthens safety practises and improves interoperability with standardized bridges, engine rooms and life-saving equipment. In November 2018, we issued an RFP for a fourth Salish Class vessel which will replace the 54-year old *Mayne Queen*. The procurement process is open to local, national and international shipyards.

Construction is underway for two Island Class vessels which will replace the 60-year old *North Island Princess* and the 54-year old *Howe Sound Queen*. The new vessels will be outfitted with hybrid diesel-electric propulsion. They will be built to be capable of conversion to all-electric propulsion as the technology permits and the necessary infrastructure is available. In December 2018, we issued an RFP for an additional four Island Class vessels, reinforcing our plan for operational efficiency, resiliency and flexibility.

The next phase of vessel renewal will include replacement of four major vessels that will have an average age of 50 in 2023 when their replacements are anticipated to begin service on our Major Routes. The new vessels will reflect capacity and levels of service consistent with the current Coastal and Spirit Class vessels in size, capabilities and passenger amenities. In October 2018, we issued a RFEOI for the procurement of up to five new major vessels. We expect to introduce an additional vessel to the fleet to accommodate future traffic and to build resiliency in the fleet.

Our Langdale terminal redevelopment project is expected to start later this year. The project includes an overhead passenger walkway, a new terminal building, parking lot and pick-up and drop-off area upgrades, as well as a ticketing plaza. This project is expected to be complete within three years and will contribute to improved safety and customer travel experience.

Our Richmond fleet maintenance facility is a strategic asset requiring upgrades and redevelopment to replace aged infrastructure. The multi-year project to seismically upgrade the site, modernize infrastructure and build a centralized shop and life raft servicing centre is in the design and development stage. The upgrades will improve operational efficiency and allow us continued and immediate access to ship repair facilities for both planned and unplanned maintenance.

Regulatory

On September 28, 2018, we filed our Performance Term Five (“PT5”) Submission with the Commissioner as required by the *Coastal Ferry Act*. The purpose of this submission is to provide information to assist the Commissioner in establishing price caps for PT5 (April 1, 2020 – March 31, 2024) for all regulated routes as specified in the CFSC between BC Ferries and the Province. The submission is comprised of five reports:

- Performance Term Four (April 1, 2016 to March 31, 2020) Report;
- Fuel Management Plan Outcomes in Performance Term Four;
- Capital Plan (fiscal years 2019 through 2030);
- Strategies for Enhancing Efficiency in Performance Term Five and Beyond; and
- Traffic Demand Forecast (fiscal years 2019 through 2024).

The Commissioner will make his preliminary determination on the PT5 price caps by March 31, 2019 and his final determination by September 30, 2019.

On January 25, 2019, the Commissioner issued Order 19-03, which supercedes Order 17-02, in which he re-established the criteria for determining a major capital expenditure which requires advance approval.

These documents are available on the Commissioner’s website at www.bcferrycommission.ca.

Financial

We expect an increase in total revenue in fiscal 2019, reflecting higher traffic levels, an increase in net catering and retail revenues, provincial contribution and ferry transportation fees, partially offset by fare reductions.

We expect an increase in total expenses in fiscal 2019, primarily due to higher wage and benefit costs resulting from the implementation of the Collective Agreement, introduction of the new mid-coast service, and a variety of initiatives to improve the customer experience, partially offset by lower vessel maintenance costs and savings from operating vessels on LNG. We continue to manage our costs prudently without compromising safe operations.

We expect positive net earnings in fiscal 2019, reflecting traffic growth and continued focus on managing costs and capacity utilization.

FINANCIAL RISKS

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 49 through 50 of our fiscal 2018 Management's Discussion & Analysis. Our risk profile is substantially unchanged during the nine months ended December 31, 2018. Our 2018 Management's Discussion & Analysis is available at http://www.bcferries.com/investors/financial_reports.html on our investor webpage.

BUSINESS RISK MANAGEMENT

Understanding and managing 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 51 through 54 of our fiscal 2018 Management's Discussion & Analysis. Our risk profile is substantially unchanged during the nine months ended December 31, 2018. Our 2018 Management's Discussion & Analysis is available on our investor webpage at http://www.bcferries.com/investors/financial_reports.html.

As part of our risk management strategies, we have considered many items such as level of earnings, 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 adapt to changes in the economic environment and ensure a viable, profitable future. We do not believe that material uncertainties exist in regards to our future as we believe our risk mitigation strategies are sufficient.

ACCOUNTING PRACTICES

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and financial performance is based upon our consolidated financial statements, which have been prepared in accordance with IFRS.

Our significant accounting policies are contained in note 1 to our March 31, 2018 audited consolidated financial statements and our December 31, 2018 condensed interim financial statements. Certain of these policies involve critical accounting estimates because they require us to make particularly subjective or complex judgements 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 judgements, 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 55 and 56 of our fiscal 2018 Management's Discussion & Analysis. The following describes the changes to critical accounting policies we have used in the preparation of our condensed interim financial statements for the three and nine months ended December 31, 2018, or expect to use in the future.

Adoption of New Accounting Standards

The following is a discussion of changes in accounting standards that we adopted effective April 1, 2018:

IFRS 15 *Revenue from Contracts with Customers* replaces IAS 18 *Revenue* and IAS 11 *Construction Contracts*, providing guidance on the amount and/or timing of recognition of revenue. We adopted IFRS 15, effective April 1, 2018 using the modified retrospective with cumulative effect method. We have assessed the recognition of our revenues under IFRS 15, using the five-step model. There is no change in our revenue recognition for the majority of our revenues. IFRS 15 requires us to recognize revenue from the expected breakage (a customer's unexercised, contractual rights to receive future services which have not been exercised but for which the customer has made a non-refundable prepayment) when the likelihood of the customer exercising their remaining rights becomes remote. At April 1, 2018, we recognized breakage revenue of \$1.2 million from our prepaid stored value card as an increase to opening retained earnings and a decrease to deferred revenue. Also at April 1, 2018, we recognized a \$0.3 million increase to deferred revenue and decrease to opening retained earnings to reflect a timing change in revenue recognition for a third party travel voucher. The application of IFRS 15 did not have a significant impact on our unaudited condensed interim financial statements.

IFRS 9 *Financial Instruments* (2014) introduces a new expected credit loss model for calculating impairment, and incorporates guidance on the classification and measurement of financial assets and the final general hedge accounting requirements originally published in IFRS 9 (2013). We adopted *IFRS 9 Financial Instruments* (2013) in fiscal 2015, and as such, were only impacted by the expected credit loss model as we adopted IFRS 9 (2014), effective April 1, 2018. This model applies to our financial assets measured at amortized cost. We have established an expected credit loss for our trade receivables. The application of IFRS 9 did not have a significant impact on our unaudited condensed interim financial statements, as we had an existing provision for impairment.

IFRS 16 *Leases* introduces a single lessee accounting model and requires a lessee to recognize assets and liabilities for all leases with a term of more than 12 months, unless the underlying asset is of low value. A lessee is required to recognize a right-of-use asset representing its right to use the underlying asset and a lease liability representing its obligation to make lease payments. We have elected to early adopt IFRS 16, effective April 1, 2018, using the modified retrospective with cumulative effect method and applying the following practical expedients on initial application:

- use of the modified retrospective approach with no restatement of prior periods. For contracts previously classified as operating leases, we elected for the right-of-use asset to equal the lease liability, adjusted for any prepaid amount; and
- electing to not recognize leases for which the underlying asset is of low value.

We recognized nine leases, formerly classified as operating leases, with a total value of \$2.9 million, as right-of use assets and with corresponding liabilities. We also reclassified our prepaid land lease and related structures as right-of-use assets.

Future Accounting Changes

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

On February 7, 2018, the IASB published Amendments to IAS 19 *Employee Benefits* which requires entities to use updated actuarial assumptions to determine current service cost and net interest for the remainder of the period after a plan amendment, curtailment or settlement. It also requires that any reduction in surplus, even amounts not previously recognized due to an asset ceiling limitation, be recognized in profit or loss as part of past service cost of a gain or loss on settlement. The amendments are effective for us on April 1, 2019. Early adoption is permitted. We are reviewing the amendments to determine the potential effects. We do not expect the application of this standard to have a significant impact on our consolidated financial statements.

The Effect of Rate Regulation

We are regulated by the Commissioner to ensure, among other things, that our tariffs are fair and reasonable. Under the terms of the Act, the tariffs we charge our customers over a performance term are subject to price caps set by the Commissioner. The Commissioner may, under certain circumstances, allow increases in price caps over the set levels. Certain decisions and orders of the Commissioner may give rise to regulatory assets or liabilities. Regulatory assets generally represent incurred costs that are probable of future recovery in tariffs or fuel surcharges. Regulatory liabilities represent obligations to customers which will be settled through future tariff reductions or fuel rebates.

We transitioned to IFRS effective April 1, 2011. At that time, IFRS did not provide any guidance with respect to accounting for rate-regulated activities.

In January 2014, the IASB issued an interim standard, IFRS 14 *Regulatory Deferral Accounts*, which addresses accounting for rate-regulated activities. However, it does not apply to entities, like ours, that transitioned to IFRS prior to that date. As a result, we are not permitted to recognize in our financial statements the assets and liabilities that result from the regulated price cap setting process, such as our deferred fuel cost accounts. Under IFRS, rather than being charged to regulatory asset or liability accounts on our consolidated statements of financial position, fuel surcharges collected or rebates granted are included in revenue, and increases or decreases in fuel prices from those approved in price caps are included in operating expenses. We are regulated by the Commissioner, and these items are treated as assets and liabilities for regulatory purposes. Reporting for rate-regulated activities provides additional information which we use to assess performance and to make operating decisions.

Regulatory assets and liabilities do not have standardized meaning within IFRS. Our regulatory assets and liabilities should be considered in addition to, but not as a substitute for, measures of financial performance in accordance with IFRS.

We continually assess whether our regulatory assets are probable of future recovery by considering such factors as applicable regulatory changes. These regulatory assets and liabilities are considered supplemental disclosures and are detailed in note 16 to our December 31, 2018 unaudited condensed interim financial statements.

If IFRS permitted us to report regulatory assets and liabilities in our financial statements, the effect on our net earnings for the three and nine month periods ended December 31, 2018 and 2017 would be as follows:

| (\$ millions) | Three months ended | | Nine months ended | |
|--------------------------------------------------|--------------------|---------------|-------------------|--------------|
| | December 31 | | December 31 | |
| | 2018 | 2017 | 2018 | 2017 |
| Net earnings | (3.7) | (14.8) | 93.2 | 100.9 |
| Changes in net earnings: | | | | |
| Regulatory asset or liability | | | | |
| Statement line item | | | | |
| Deferred fuel costs | | | | |
| Fuel costs over (under) set price | 2.2 | (1.2) | 1.1 | (7.5) |
| Fuel rebates | - | 4.1 | 4.6 | 15.7 |
| Payments from the Province | - | - | - | 0.3 |
| (Decrease) increase in total net earnings | 2.2 | 2.9 | 5.7 | 8.5 |
| Adjusted net earnings | (1.5) | (11.9) | 98.9 | 109.4 |

Deferred fuel costs: As prescribed by regulatory order, we defer differences between actual fuel costs and regulated fuel costs which were used to develop the regulated price caps. The difference between actual fuel costs (including fuel hedge gains and losses) and the regulated fuel costs (set price) is deferred for settlement in future tariffs. In addition, as prescribed by regulatory order, we collect fuel surcharges or provide fuel rebates from time to time which are applied against deferred fuel cost account balances. We may also receive payments from the Province to be applied against deferred fuel cost account balances.

Fuel rebates were discontinued on June 27, 2018 (fiscal 2019) due to the rise in fuel prices.

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 CFSC.

Forward looking statements included in this document include statements with respect to: economic conditions, traffic levels, fares, and fiscal 2019 net earnings; the Province's review of the CFSC; our short-term and long-range business plans, capital expenditure levels, Performance Term Five Submission, and asset renewal programs for vessels and terminals; our customer experience program, Fare Flexibility and Digital Experience Initiative, and pricing promotions; the *Northern Sea Wolf* and the seasonal direct ferry service between Port Hardy and Bella Coola, the minor class vessel replacements, the major class vessel replacements, the Island Class vessels, Spirit Class mid-life upgrades, the Langdale terminal redevelopment project, and the fleet maintenance facility project; the FortisBC incentive funding, and the New Building Canada Fund; our expectations regarding food sales and sales of quality apparel; total revenue and expense projections, and how our cash requirements will be met in the near term; and our expectations regarding the impact of amendments to IAS19 on our consolidated financial statements. 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: vendor non-performance; capital market access; interest rate, foreign currency, fuel price, and traffic volume fluctuations; the implementation of major capital projects; security, safety, and environmental incidents; confidential or sensitive information breaches; changes in laws; vessel repair facility limitations; economic regulatory environment changes; tax changes; and First Nation 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.

NON-IFRS MEASURES

In addition to providing measures prepared in accordance with IFRS, we present certain financial measures that do not have any standardized meanings prescribed by IFRS and therefore are unlikely to be comparable to similar measures presented by other companies. These include, but are not limited to, net earnings adjusted for the effect of rate regulation and average tariff revenue per vehicle and per passenger. These supplemental financial measures are provided to assist readers in determining our ability to generate cash from operations and improve the comparability of our results from one period to another. We believe these measures are useful in assessing operating performance of our ongoing business on an overall basis.