Management Discussion and Analysis

This discussion and analysis presents data and comments on the Corporation's financial position and results of operations for the year 2003. It should be read in conjunction with the Financial Statements, which follow.

Since the last Special Examination of VIA in 1998 concluded that there were 3 significant deficiencies, the Board of Directors noted the clear progress and continuous improvements in Management practice when the Auditor General tabled the following introduction of the 2003 Special Examination report. The 2003 report also identified other improvements to the effectiveness of VIA's management systems and practices.

To: The Board of Directors of VIA Rail Canada Inc.

Objective of the Special Examination

1. The *Financial Administration Act* (FAA) requires VIA Rail Canada Inc. to undergo a special examination at least once every five years. The purpose of the special examination is to determine whether VIA is maintaining systems and practices in a way that provides reasonable assurance that its assets are safeguarded and controlled; its financial, human, and physical resources are managed economically and efficiently; and its operations are carried out effectively.

Special Examination Scope and Approach

2. We based our special examination plan on a preliminary survey of VIA's systems and practices that contribute to achieving the Corporation's expected results (see Appendix B), and an analysis of the risks associated with them. We presented the plan to the Board's Finance and Audit Committee on 2 December 2002. The plan outlined the systems and practices that we would examine in detail — the systems and practices that are essential to ensuring that assets are safeguarded and controlled, that resources are managed economically and efficiently, and that the operations are carried out effectively. Other systems and practices included in the preliminary survey were not selected for detailed examination, because our analysis indicated that their significance and the associated risks did not have a decisive impact on VIA's activities. The plan defined the criteria by which we would assess the appropriateness of the systems and practices we examined (see Appendix A). The examination took place between May 2002 and January 2003.

3. Our responsibility is to express an opinion as to whether, during the period under examination, there was reasonable assurance that there were no significant deficiencies in the systems and practices examined. Our examination was carried out in accordance with the plan and the standards for assurance engagements of the Canadian Institute of Chartered Accountants. Accordingly, it included such tests and other procedures as we considered necessary in the circumstances.

4. During our special examination, we interviewed members of the Board of Directors, management, and employees. We examined key documents, met with Transport Canada and CN representatives, and visited certain VIA facilities. We also relied on internal audit work in the areas of management of food and beverage stocks (Montreal and Toronto services centers); service delivery in the Eastern Corridor and southwestern Ontario; management of risk and assurances; inspection and maintenance; and contracting policies. Finally we used the findings of certain assessments conducted by qualified specialists, particularly those that dealt with governance and the safety management system.

5. We excluded from our special examination the infrastructure project for high-speed train in the Quebec City – Windsor Corridor because the project was still being studied and had not received backing from the government. In addition, we conducted only a limited audit with respect to the code of ethics developed by the Corporation because our Office has another audit project under way at VIA, examining advertising contracts, public opinion research contracts and sponsorship programs in federal departments and Crown corporations. The report to Parliament on that audit is planned for November 2003. A number of ethical questions will be examined during the audit.

Opinion

In our opinion, with respect to the criteria established for the examination, there is reasonable assurance that there are no significant deficiencies in the systems and practices examined.

Sheila Fraser, FCA
Auditor General of Canada

Montréal, Canada, 31 January 2003

Revenue and ridership

As discussed earlier in this report, 2003 has been a disastrous year for the tourism and transportation industry in Canada. Events beyond VIA's control have had a negative impact on VIA's revenues and ridership.

Total revenues for 2003 were $250.3 million, a drop of $20.5 million, or 7.6 per cent compared to 2002. With 3.8 million passengers carried in 2003, ridership dropped 4.8 per cent compared to the previous year. For the first time in many years VIA's revenue/cost ratio decreased, falling to 58.5 per cent compared to 64.5 per cent in 2002.

Per cent decline by region, 2003 vs. 2002

	Ridership	Passenger Revenue
Corridor East (Toronto to Quebec City)	-0.8%	-2.3%
Corridor West (Toronto to Windsor)	-7.5%	-11.4%
Eastern (Montreal to Halifax)	-10.4%	-17.4%
Western (Toronto to Vancouver)	-14.0%	-18.6%
Total system	-4.8%	-8.9%

The most significant declines were on routes where leisure and tourism travel dominate. Business travel accounts for a substantial proportion of VIA's ridership, and was less vulnerable to the negative market conditions in 2003. As a result, the decline in revenues and ridership in the Quebec City – Toronto Corridor was comparatively lower, which helped to mitigate the impact on the system as a whole.

Performance relative to the industry

While the bottom-line results compared to 2002 are less than satisfactory, VIA's results compare favourably with industry averages. While direct comparisons are difficult, it seems clear that VIA performed significantly better than most companies in the travel and tourism industry. The travel market as a whole experienced much steeper declines in volumes than VIA, and estimates show that the drop in total travel and tourism spending was much greater than the drop in VIA's revenues.

VIA's performance in context

Decline in US travel to Canada (1)	13.7%
Decline in Overseas travel to Canada (1)	16.0%
Decline in domestic travel (2)	8.0%
Decline in VIA ridership	4.8%

Sources: 1) Statistics Canada, Q3 Reports; 2) Statistics Canada, Q2 Reports

In the Quebec City – Windsor Corridor, VIA's market share of public mode travellers increased each quarter of 2003, with a total increase of 4.2 per cent. Air travel lost market share by 3.3 per cent, and bus services by 0.9 per cent.[3]

In the last quarter of 2003, VIA's passenger volumes increased significantly in the Quebec City – Windsor Corridor, reaching the highest passenger volumes attained in any fourth quarter since 1990, indicating that passenger rail is recovering ridership gains achieved in recent years.

Operating costs

Cash operating expenses for 2003 were $431.4 million, an increase of 1.7 per cent over 2002.

VIA was able to mitigate the impact of the revenue decline in 2003 by implementing tight cost controls in areas such as compensation, train operations, on-train product costs, and fuel expenses. Compensation costs were reduced by not staffing vacant positions, controlling labour levels and optimizing operations. Non-compensation operating costs were also reduced significantly compared to the previous year, including $0.4 million savings in fuel costs and reductions of $0.8 million in linehaul charges due to shorter trains. Savings in on-train product costs produced a $1.0 million reduction while marketing revenue driven and telecom expenses were cut by $1.7 million.

As a result of these efforts, VIA was able to offset more than 60% of the $33.6 million shortfall in its 2003 revenue budget with cost savings. To cover the remainder of the shortfall, VIA received approval from the Treasury Board to reallocate $12.6 million of unspent capital funding, thus ensuring that there were no additional costs to government this year as a result of 2003's depressed travel market.

VIA will continue to streamline costs in 2004 wherever possible. However, since over 80 per cent of operating costs and employees are tied to basic train operations, significant cost reductions can only be achieved by reducing services. Barring service cuts, further reductions in VIA's operating subsidy can only be achieved by increasing revenues. At this time, significant revenue growth depends upon capital investment to increase the capacity of the rail infrastructure, reduce trip times, add frequencies and improve on-time performance of passenger trains.

3 — Pollara — Continuous tracking telephone survey (Toronto, Montreal, Ottawa, Quebec City), 4th quarter 2003.

On-time performance

On-time performance decreased from 84 per cent in 2002 to 73 per cent in 2003, lower than it has been at any time over the past 16 years. VIA recognizes that this is a very critical problem, with potentially disastrous effects on VIA's financial performance if the root cause of the problem is not addressed quickly. Increasing freight traffic on the rail infrastructure, operating in ways that are incompatible with efficient passenger service operations, will seriously limit VIA's ability to continue increasing revenues and reducing costs if it is unable to operate its services on schedule. Deteriorating performance will lead to lost business, lower revenues, and possibly higher costs to government.

Of the train delays experienced in 2003, only 20 per cent were directly under VIA's control. A significant proportion of these delays were related to the introduction of new equipment. The different operating characteristics of new locomotives and passenger cars required that schedules be adjusted; however, schedules could not be adjusted effectively until the equipment was tested and evaluated in service. Once field operating characteristics were determined, schedules were adjusted appropriately.

VIA continues to seek ways to minimize delays in its own operations, including changes in station practices to minimize station stand time, and improved baggage handling procedures to reduce delays en route.

Responsibility for Delays

	2003
VIA	20%
CN	61%
Other Railways	6%
Third parties	13%

However the majority of train delays were caused by CN (61 per cent), with other railways and third parties accounting for another 19 per cent of delays. The significant volume of CN-related delays is due largely to major increases in CN's freight rail business, which has consumed a much larger portion of the capacity on infrastructure owned by the railway.

Along with increased freight traffic, changes in the nature of CN's freight operations have also affected VIA's trains. CN is operating much longer, slower freight trains, which often exceed the capacity of sidings, forcing passenger trains to slow down more frequently, and causing increased wear on the infrastructure. This in turn has increased the need for CN to conduct track maintenance operations, again delaying passenger trains. In addition, the longer freight trains have experienced more frequent mechanical problems and breakdowns, including broken drawbars and couplings. Each one of these breakdowns causes delays for VIA, and VIA's passengers.

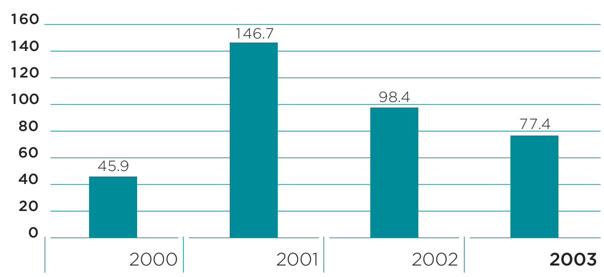
VIA works closely with CN to identify and, to the best of its ability, resolve problems that cause passenger service delays. However, like any business, CN must respond to its own opportunities for growth, and make operating decisions based on the need to manage its core business efficiently. Despite the best efforts of both CN and VIA, it is becoming clear that the current approach is reaching the limits of its potential to resolve the operating challenges VIA is facing. On critical portions of the infrastructure — particularly in the busy Quebec City – Toronto Corridor — the only long-term solution is to address the infrastructure capacity issue directly, and to separate passenger and freight rail operations wherever possible.

Capital Expenditures

Capital expenditures were $77.4 million in 2003, $24.5 million below the approved Capital funding of $101.9 million. In 2003, almost 84 per cent of capital expenditures were related to equipment projects. For example, the Renaissance car project represented an investment of $54.0 million dollars and accounted for 70 per cent of 2003 capital expenditures. Other significant equipment expenditures included the Waste Management (long-haul cars) project that required an investment of $8.4 million in 2003.

Capital Expenditures

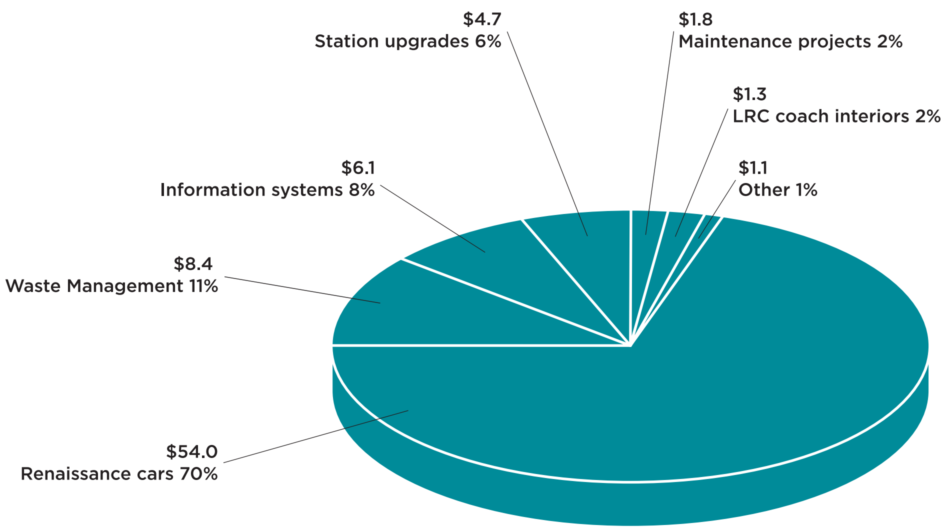
(IN MILLIONS OF DOLLARS)



Station upgrading projects accounted for another $4.7 million of the 2003 Capital expenditures and involved projects such as the Toronto Union Station and Halifax Station renovations. Investments relating to Information Systems totaled $6.1 million in 2003 and involved projects such as the Telephone Sales Office (TSO) technology upgrade, the self-serve ticketing kiosks and the Internet booking engine.

Nature of 2003 Capital Expenditures

(IN MILLIONS)



Outlook for 2004

VIA's ridership and revenues had already started to recover during the last quarter of 2003 as volumes and revenues in the Quebec City – Windsor Corridor showed an increase. Services in Eastern and Western Canada, however, remained weak.

The Conference Board of Canada forecasts that domestic travel will increase at an annual rate of 2.5 per cent in the first quarter of 2004, and 8.5 per cent in the second quarter. US travel to Canada is expected to decline a further 1.5 per cent in the first quarter, but should begin to recover in the second quarter with a growth rate of nine per cent. Travel from Europe and Asia is expected to increase by three per cent in the first quarter, with stronger gains in the second quarter — 8.5 per cent for Europe, and 12 per cent for Asia. Travel growth from Japan, in particular, is expected to be strong.

As markets continue to recover from the shocks of 2003, VIA is determined to strive for above average performance, continuing to increase market share for passenger rail where possible, and improve operating performance significantly in the coming year.

In order to return revenues to the upward trend established over the past decade, and minimizing costs, VIA will:

— Continue to implement rigorous cost controls to eliminate unnecessary costs, without jeopardizing services.

— Continue to introduce promotional discounts to increase the visibility of passenger rail as an attractive option in the marketplace.

— Continue to market promotional initiatives aggressively to attract new customers, confident in VIA's ability to retain these customers.

— Improve and enhance service delivery to capitalize on its competitive edge over other modes of transportation.

— Implement all possible measures to improve on-time performance.

However, any optimism for the coming year must be tempered by grave concerns about limited infrastructure capacity, and the impact this is having on on-time performance. Many of the infrastructure and capacity problems experienced in 2003 will continue, and increase, if they are not addressed quickly.

VIA is working closely with the freight railways and the federal government to examine options for resolving these issues. VIA is confident that viable options will be identified which, if implemented, would allow the Corporation to continue increasing revenues, thereby ensuring that the national passenger rail service will grow to meet Canada's transportation needs in the years ahead.