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 2005. It should be read in conjunction with the Financial Statements, which follow.

OVERVIEW OF FINANCIAL RESULTS

VIA delivered exceptional financial results in 2005, continuing and surpassing its strong financial performance in 2004. Despite the pressures of turbulent travel markets and rising operating costs, the Corporation considerably reduced its net operating deficit, both as compared to budget and to 2004.

This exceptional performance reflects a significant increase in passenger revenues, and revenue from a one-time recognition of capital gains in VIA's Asset Renewal Fund investment portfolio. Total revenues in 2005 hit an all-time high of $289.8 million. This is $26.3 million (or 10 per cent) higher than budget and $31 million (or 12 per cent) higher than 2004.

Higher revenues more than offset higher than expected operating expenses, enabling the Corporation to end its financial year with an operating deficit of $175.9 million. This represents a substantial reduction of $14.9 million (or eight per cent) compared to budget and $9.2 million (or five per cent) compared to 2004.

Annual operating funding for passenger rail from the federal government has been frozen at $169 million since 1999. The Corporation must use its internal resources (the Asset Renewal Fund) to make up the difference between government funding available and the actual funding required. Due to the excellent financial results, VIA was able to reduce its 2005 funding shortfall, and therefore the amount of funding required from the Asset Renewal Fund, to $6.9 million. This is $14.9 million (or 68 per cent) better than anticipated.

REVENUE AND RIDERSHIP

Both revenue and ridership exceeded budget targets in 2005. This growth is particularly significant given the uneven performance of the Canadian travel market as a whole, with some key international markets experiencing no growth during the year.

Following the JetsGo bankruptcy in March, VIA benefited from a surge in domestic market demand, including a high percentage of new rail users. Flexi Fares, introduced earlier in January, helped VIA to retain these new customers by offering simplified, more flexible purchase options. Flexi Fares also produced higher yields compared to 2004 and improved usage of capacity.

A fare adjustment introduced at mid-year, largely to offset higher energy costs, had no negative effect on demand, as airlines had already increased fares.

Overall, revenue per passenger-mile increased to 28.6 cents, over two per cent higher than 2004. Passenger revenues increased $15 million over 2004, exceeding budget targets by over six per cent. Passenger-miles, at 888 million, grew over four per cent as a result of strong Corridor ridership and recovery of long-distance travel markets in Eastern and Western Canada. Ridership reached 4.1 million passenger trips in 2005, a record for the current passenger rail network.

While facing revenue challenges in the first part of the year, VIA met and exceeded targets as of mid-year. Beginning in September, passenger revenue growth accelerated significantly. Between September and December, passenger revenues increased by over nine per cent and passenger ridership grew by approximately six per cent as compared to 2004. *Comfort* class experienced both strong revenue and ridership growth in 2005. *VIA 1* and sleeper classes recorded revenue growth, but only minimal ridership increases.

OPERATING COSTS

Total operating costs in 2005 were influenced by a number of one-time and recurring factors, which caused expenses to exceed budget by $11.5 million, or three per cent. Compared to 2004, total operating expenses increased by five per cent.

Rising fuel prices were a major source of increased costs. However, the negative effects on VIA's financial results were attenuated somewhat in 2005 by the use of fare adjustments and hedging techniques, which sheltered the Corporation from the full impact of increases in the price of oil.

Changing financial conditions affecting the pension plan for VIA's unionized employees also influenced operating costs, and will continue to do so in the years to come. As required by the *Income Tax Act*, the Corporation did not contribute to the unionized plan for a number of years. VIA resumed contributions in 2005 as a result of the deteriorating financial position of the plan. These unplanned contributions started during the second half of the year and totalled $5 million.

In addition, accident costs and provisions for third party claims jumped in 2005, exceeding budget by $4 million.

The overall increase in operating costs masks the impact of the Corporation's stringent control of costs. Despite rising fuel prices and cost increases associated with poor on-time performance on the Western and Eastern long-haul services, costs for train operations – including fuel, maintenance material, and station and property expenses – were below budget for 2005, but nearly $10 million more than last year. Marketing and sales expenses, as well as on-train product costs, were up versus last year and higher than budget, but this is due to higher passenger volumes and revenues.

CAPITAL EXPENDITURES

At the present time, the government has approved no new capital funding for passenger rail. VIA is thus obliged to use the internal Asset Renewal Fund not only to satisfy its capital requirements but to cover operating funding shortfalls as well.

VIA originally planned to spend $32.4 million on capital expenditures in 2005, funded almost entirely through the Asset Renewal Fund. Actual spending for 2005, however, totalled only $21.2 million, which is $11.2 million less than planned.

This under-spending is in part a reflection of VIA's prudent management of its scarce capital resources. The continued absence of an expected government decision to approve new capital funding for 2006 left VIA at risk of having no capital funding in that year. Therefore, VIA decided to revise its 2005 capital spending plans so as to reallocate some of its remaining Asset Renewal Funds to 2006 to provide for a minimal level of capital investment in that year. This involved the cancellation of planned projects to permit the transfer of $5 million dollars of capital funding from 2005 to 2006.

ON-TIME PERFORMANCE

VIA achieved a substantial improvement in on-time performance for the first time in the last four years. Overall on-time performance reached 81 per cent for 2005, an 11 percentage point improvement over 2004. This is one of the best gains in VIA's history. Most notable were improvements achieved over the Christmas period and during the difficult winter months.

VIA tracks delay minutes and distinguishes between those caused by its own operations and those attributable to infrastructure owners or other third parties. As such, VIA addressed critical problems in areas under the Corporation's direct control, such as equipment maintenance and passenger handling. Equipment maintenance delays for the Quebec City-Windsor corridor decreased 18 per cent compared to 2004, and passengers experienced fewer service disruptions related to mechanical failures. Another factor contributing to improved performance was the efforts of the Customer Service department, which achieved a 31 per cent reduction of non-mechanical delay minutes compared to 2004.

The Western transcontinental service suffered a significant rise in CN-related delays for a second consecutive year. Delay minutes increased by 38 per cent over 2004, resulting from a combination of increased freight congestion and derailments. Some delays resulting from track congestion are due to a major undertaking by CN to increase the capacity of its sidings, which will continue into 2006. VIA is working closely with CN to minimize delays resulting from such work projects, which will ultimately improve on-time performance.

The Eastern transcontinental service faced challenges of its own. On-time performance fell eight percentage points from 2004. Shortline railway delays more than doubled during 2005 as result of a need for reduced speed.

OUTLOOK FOR 2006

VIA is confident that it will sustain and further improve a high level of performance for passenger rail in 2006. The Conference Board of Canada predicts that travel in Canada will grow by 2.6 per cent, roughly in line with industry growth during 2005. VIA expects to match or exceed this rate of growth, by continuing to focus on customer service and the key goals set out in the *Moving Forward* plan.

With the prospect of continued increases in basic operating expenses, VIA will maintain rigorous cost controls, explore new opportunities to improve productivity, and capitalize on new market opportunities. Efforts to enhance web-based marketing and sales options and other technologies will respond to growing demand from customers, while further reducing distribution costs. Efforts to increase ridership will focus on fine tuning existing services, managing capacity in off-peak periods, and exploring opportunities to re-deploy fleet capacity in markets that show long-term growth potential.

While VIA enters 2006 with confidence, the Corporation remains very concerned about the financial stability of Canada's passenger rail service, and prospects for maintaining a quality service in the longer-term. While operating costs are rising substantially, operating funding for the service remains frozen at 1999 levels, creating a significant funding shortfall. VIA has managed to cover this shortfall by using funds intended for capital investment, but those funds will be exhausted by the end of 2006.

Capital investment, in turn, has been postponed, pending decisions from the federal government with respect to the future role of passenger rail in national transportation. Indefinite delays in critical investment will affect the performance of passenger rail, and ultimately its viability as a service to Canadians.

VIA will make every effort to continue improving the on-time performance of passenger rail, which depends largely on the infrastructure owned by freight railways. Cooperation between VIA and CN to address capacity issues has achieved excellent results, and will continue. However, it is clear that long-term solutions with respect to infrastructure will require investment to increase capacity, and to improve infrastructure owned by shortline operators.

VIA will continue to work closely with the Government of Canada to explore a long-term vision for the future of passenger rail, and options for investing in that future. The Corporation is confident that, with a clear vision in place, passenger rail will continue to be a relevant and cost-effective transportation service for Canadians.