

NATIONAL CHALLENGE SYSTEMS INC.
Management Discussion and Analysis
Nine Months Ending March 31, 2006

MANAGEMENT DISCUSSION & ANALYSIS

The following is a discussion of the consolidated financial condition and results of operations of National Challenge Systems Inc. for the nine-month period ended March 31, 2006. This discussion should be read in conjunction with: the Unaudited Interim Consolidated Financial Statements of the Company and notes thereto for the nine months ended March 31, 2006, "Management's Discussion and Analysis" for the year ended June 30, 2005 and the Audited Consolidated Financial Statements and notes thereto for the year ended June 30, 2005.

FORWARD-LOOKING STATEMENTS

Certain statements made or incorporated by reference in this MD&A are forward-looking and relate to, among other things, anticipated financial performance, business projects, strategies, regulatory developments, new services, market forces, commitments and technological developments. By its nature, such forward-looking information is subject to various risks and uncertainties, including those discussed in this MD&A or in documents incorporated by reference in this MD&A, which could cause the Company's actual results and experience to differ materially from the anticipated results or expectations expressed. Readers are cautioned not to place undue reliance on this forward-looking information, and the Company undertakes no obligation to update publicly or revise any forward-looking information, whether as a result of new information, future events or otherwise, except in accordance with applicable securities laws.

RESULTS OF OPERATIONS

Appointment

During the third quarter the Company appointed Mr. Ian M. London to the National Challenge Board of Directors. Mr. London is a proven senior business executive with a strong Canadian and international track record of leading organizations through growth, innovation and change. Mr. London brings more than twenty years experience in senior positions in the power sector to National Challenge. His knowledge of the Ontario and international electricity generation industries will assist the Company with its renewable energy efforts.

Previously, Mr. London spent twenty-five years working for Hydro One (formerly Ontario Hydro) where, amongst other roles, he served as Senior Vice President, Corporate Business Development; Director of Grid Strategies and Plans, and Director of Engineering & Construction Services. Mr. London also served as President & CEO of Ontario Hydro International.

Mr. London holds an MBA from York University and a Bachelor of Engineering degree from McGill University. Mr. London also attended the Ivey School (University of Western Ontario), where he took the International Management Program.

Revenue

Revenue for the three months ended March 31, 2006 was up 9% or \$352,000 from \$3,751,000 in third quarter of 2005 to \$4,103,000 in third quarter of 2006. Year to date revenue was up 15% or \$1,550,000 from \$10,526,000 in 2005 to \$12,076,000 in 2006. The increase is primarily the result of the price increase to its Ontario customers that the Company put into effect beginning in December 2004 in order to offset the increase in recycling costs.

Operating Results

The contribution margin was down 7% or \$68,000 from \$961,000 for the third quarter 2005 to \$893,000 for the third quarter 2006 reflecting the increasing recycling costs during the quarter. The contribution margin for year to date is up 7% or \$178,000 from \$2,660,000 in 2005 to \$2,838,000 in 2006. Year to date the contribution margin as a percentage of the revenue was down from 25.3% in 2006 compared to 23.5% in 2005.

In light of the recent developments in Ontario, and the Company's knowledge of organic recycling options in general, NCS believes that an anaerobic digestion industry is emerging in Ontario, and that it will ultimately provide a low-cost, long-term recycling solution for all of the organic residuals the Company does and can collect. As a result, the Company has decided to suspend efforts to re-permit and expand its Direct Land Application Process ("DLAP") facilities in Ontario. In the interim, the Company continues to use higher cost recycling alternatives including transporting material out of province to third party recycling sites. Consequently, waste recycling costs year to date are up 41% over the last year.

Year to date vehicle maintenance costs are up \$149,000 over last year reflecting the aging of the fleet. The Company is embarking on a program that will see over \$1 million in new trucks added to the fleet in the next 6 months.

Cash operating expenses were up \$170,000 from \$649,000 to \$819,000 respectively for the third quarters of 2005 and 2006. The increase reflects the impact of a sales tax assessment credit in 2005 and increased costs in 2006. Year to date cash operating expenses are \$2,007,000 and \$2,355,000 respectively for 2005 and 2006 and as a percentage of revenue steady at 19%.

Non-cash operating expenses were down \$18,000 from \$491,000 for the third quarter of 2005 compared to \$473,000 for the same quarter in 2006. Year to date non-cash operating expenses were down \$16,000 from \$1,428,000 in 2005 to \$1,412,000 in 2006.

Year to date the net loss increased by \$154,000, from \$775,000 in 2005 to \$929,000 in 2006. The net loss for the third quarter of 2006 was \$398,000 up \$219,000 from the net loss of \$179,000 in the third quarter of 2005. The Company continues to have large non-cash operating expenses including amortization of intangible assets related to the acquisition of its two operating subsidiaries, and the amortization of these intangible assets was \$242,000 in the third quarters of both 2006 and 2005 and year to date of \$727,000 in both 2006 and 2005.

Quarterly Review

Financial Information - Eight Quarter Summary

(in 000's except earnings per share)

	<u>Third Quarter</u>		<u>Second Quarter</u>		<u>First Quarter</u>		<u>Fourth Quarter</u>	
	<u>Ending March 31</u>	<u>2005</u>	<u>Ending Dec 31st</u>	<u>2005</u>	<u>Ending Sept 30th</u>	<u>2005</u>	<u>Ending July 31st</u>	<u>2004</u>
Revenues	\$ 4,103	\$ 3,751	\$ 4,008	\$ 3,446	\$ 3,966	\$ 3,329	\$ 3,968	\$ 3,178
Net Loss	(398)	(179)	(305)	(299)	(225)	(297)	(355)	(933)
Net loss including items not involving cash	74	312	173	188	242	153	307	30
Cash flows from operating activities	395	54	(237)	30	389	207	383	(125)
Loss per share, basic and fully diluted	\$(0.01)	\$(0.00)	\$(0.01)	\$(0.01)	\$(0.01)	\$(0.01)	\$(0.01)	\$(0.03)

In December 2004 the Company began increasing rates to most of the Ontario customers in order to offset the erosion to the gross margin that had occurred from the increase in recycling costs. By March 31, 2005 over 95% of all Ontario based customers had received rate increases with the balance in place by June 30, 2005. As a result, the revenues for the three quarters of fiscal 2006 compared to fiscal 2005 are on average 15% ahead of the revenues from the comparable periods of the prior years.

The increasing loss through the first three quarter of 2006 reflects the increasing recycling costs and has again triggered the Company to seek rate increases from customer in Ontario.

The \$355,000 net loss for the fourth quarter of 2005 includes \$322,000 write down of property plant and equipment related to compactors. This is a non-cash item.

The net loss of \$933,000 in the fourth quarter of 2004 was particularly larger than the fourth quarter of 2005 due to three non-cash operating expenses recorded during that quarter:

- Accrued dividends on the class A preferred shares of \$209,000 in the fourth quarter of 2004 compared to \$74,000 in the fourth quarter of 2005.
- Future tax expense of \$197,000 in the fourth quarter of 2004 compared to a future tax recovery of \$142,000 in the fourth quarter of 2005.
- \$134,000 of stock based compensation compared to none in the fourth quarter of 2005.

Balance Sheet & Cash Flow

For the first nine months of 2006, cash flow from operating activities improved by \$257,000 or 88% from \$291,000 in 2005 to \$548,000 in 2006. Last year there was an increase in accounts receivable of \$495,000 mainly related the price increase in the third quarter of 2005.

Accounts receivable decreased by \$82,000 from \$2,297,000 at June 30, 2005 to \$2,215,000 at March 31, 2006. For the third quarter of fiscal 2006, accounts receivable decreased by \$120,000 reflecting the return to normal payment cycle after the holiday season.

Accounts payable and accrued liabilities decreased by \$37,000 from \$2,357,000 at June 30, 2005 to \$2,320,000 at March 31, 2006. For the third quarter of fiscal 2006, accounts payable increased by \$222,267.

For the first nine months of 2006 the Company acquired \$166,000 of property plant and equipment. In the same period last year \$989,000 was acquired; however, this included the acquisition of land and building related to the Toronto plant for \$901,000.

Long-term debt and capital leases were reduced by \$403,000 for the first nine months of 2006 compared to an increase of \$328,000 for the same period of 2005.

RISKS & UNCERTAINTIES

The Company needed to offset the erosion to the gross margin that has occurred from the increase in Ontario recycling costs. Therefore after careful assessment and review, a decision was taken to increase rates to the Ontario customers. By May 1, 2006 over 90% of all Ontario based customers will receive significant rate increases.

The Company has successfully increased customer rates in the past, but with any price increase there is a risk that the Company may lose accounts. The price increase should have a positive impact on the Company's operating contribution, subject to the amount of lost business.

A union certification vote was held at the Toronto facility of its wholly owned subsidiary Organic Resource Management Inc. on March 29, 2006. The majority of the approximately 25 employees at that facility voted in favour of certifying the Universal Workers Union as their representative.

At this point in time it is not known what will happen with respect to labour costs as a result of the union certification at the Toronto facility. The Company has to proceed through the collective bargaining process in order to determine what, if any impact may occur. National Challenge's operations in British Columbia have operated successfully with a unionized hourly labour force for over 30 years.

STRATEGY

NCS growth strategy is to use state-of-the-art technologies, both proprietary and otherwise, together with its substantial operational management expertise to capitalize on the opportunity presented by a large, and fragmented organic and other non-hazardous liquid residuals vacuum truck services industry in North America.

NCS' centralized customer service, dispatch infrastructure and service delivery optimization systems can be deployed to deliver a broad range of services to existing Vacuum Truck Operators (VTOs) and the authorities that regulate this industry throughout North America.

NCS' long term growth plans include acquiring existing VTOs and establishing new VTOs in select new markets. NCS can also provide operational management services to existing VTOs in markets that it does not wish to directly participate in.

During the third quarter the Company successfully equipped all its field service technicians with wireless handheld units at the Toronto facility using NCS' proprietary handheld software.

One of the most significant benefits of this new handheld technology for NCS will be the elimination of the more than 75,000 paper work orders annually and the ability to deliver electronic work orders anywhere, anytime via wireless technology. NCS should realize a direct cost saving associated with the elimination of paper and the handling that goes with it, but more importantly, this will allow NCS to deploy its workforce throughout North America from its existing Woodbridge logistics call center location.

Recycling options for the wastes that the Company collects vary from region to region and market to market. The Company's strategy with respect to recycling the residuals it collects includes controlling a significant portion of the lowest cost, most beneficial recycling options in the markets it services either by obtaining preferential supply agreements, through equity participation or through outright ownership. NCS is continually exploring and monitoring the progress of every potential recycling option that could use the organic residuals that it collects.

One of these recycling options is anaerobic digestion (AD). AD converts organic waste into methane gas that can be used to generate steam or electrical energy thereby providing a continuous source of renewable energy. Anaerobic digestion of organic residuals for biogas production is a widely proven technology that has been in constant use in Europe for 20 years.

The Ontario Government unveiled a proposed Standard Offer Program (SOP) in September 2005 that, when implemented, could encourage the development of small generators of "clean", renewable electricity by allowing them to sell into the Ontario power grid at a fixed premium. On March 21, 2006, the Government confirmed the SOP and announced the general terms under which it would proceed, which includes a long-term fixed price (20 year) contract. A key goal of the SOP is to make anaerobic digestion for biogas energy production financially viable in Ontario.

The Company believes that this initiative will provide the stimulus to make at least some ADs economically feasible in Ontario. Anaerobic digesters would provide National Challenge with an opportunity to leverage its position as a leading collector of liquid organics by supplying these digesters with energy rich, high fat, oil and grease (FOG) residuals that produces substantially higher methane yields than other organic residuals, such as food waste and manure.

The development of ADs in Ontario could be a long-term renewable energy solution that could make a significant contribution to Ontario's clean energy requirements. At the same time, it would provide an alternative for managing farm manures that would facilitate the objectives of the Nutrient Management Act as set out by the Ministries of Agriculture and Environment and provide the Company with a virtually unlimited low-cost recycling option for the organics it collects in this its largest market.

The Company's large supply FOG content liquid organics significantly boost AD biogas production when combined with other organics such as farm manures. As a result, the Company's FOG residuals will become a valuable feedstock for renewable energy production, making NCS a preferred partner among Ontario AD project developers.

Following the March 21, 2006 SOP announcement, NCS initiated contractual discussions with selected developers of AD projects. These projects would produce biogas energy that qualifies under the SOP. A key goal of the SOP is to make anaerobic digestion for biogas energy production financially viable in Ontario. AD converts raw organic materials such as agricultural and other food-related residuals into reliable streams of biogas for electricity generation, thus creating a sustainable renewable energy supply. It is uncertain to what extent the AD industry will expand under the price that the Government of Ontario has proposed in the SOP. ADs have two

sources of revenues: 1) the price they receive for the electricity they generate, and 2) the “tip” fee they would receive for receiving and co-digesting off-farm organic residuals such as those collected by NCS.

The Company’s large supply of high-content fats, oils and greases (FOG) liquid organics have the potential to significantly boost AD biogas production when combined with other organics such as farm manures. As a result, the Company’s FOG residuals could become feedstock for renewable energy production, making NCS a preferred partner among Ontario AD project developers.

Moreover, ADs could offer NCS a secure and long-term recycling solution for large volumes of organic residuals, thereby adding much needed organics recycling capacity in Ontario. New capacity would enable the Company to accelerate market and revenue growth by providing reliable collection services in Ontario to a wider geographic area, as well as to customers with large organic residual streams that have not been serviced previously due to a lack of recycling capacity.

In addition to the SOP, there are also changes required to existing government regulations to manage the practical implementation of AD facilities, NCS believes the Province has made a decisive first step and is committed to making this sector viable, and that ultimately there will be an AD industry in Ontario.

Bruce ECO-Industrial Park Feasibility Study

In October 2005, the Company announced it had entered into a Letter of Intent with Canadian Agra Inc. to conduct a feasibility study. The study examined the establishment of a transfer station to manage organic residuals, and a centralized anaerobic digester that would co-process those residuals along with livestock manures to produce steam energy for the Bruce ECO-Industrial Park (BEIP) which is located near Kincardine Ontario.

The results of that Study lead the Company to conclude that as ADs become viable in Ontario, it is likely that numerous farm ADs will emerge creating a demand for the Company’s organic material. The Company also believes that the Government is committed to removing regulatory barriers to allow these farm-based ADs to process off-farm organic feedstock such as that collected by the Company, to produce renewable energy. Further, and primarily as a result of their geographic positioning, farm-based ADs would provide better long-term opportunities for the Company than the single large site proposed by BEIP.

NCS intends to maintain open and continuous communication with Canadian Agra as the AD industry develops in Ontario.

ADDITIONAL INFORMATION

Further information about NCS may be obtained at the Company’s web site at www.nationalchallenge.com .

Financial Statements of
NATIONAL CHALLENGE SYSTEMS INC.

(Unaudited)

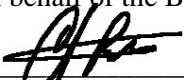
March 31, 2006

NATIONAL CHALLENGE SYSTEMS INC.
CONSOLIDATED BALANCE SHEETS

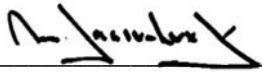
	MARCH 31	JUNE 30
	2006	2005
ASSETS		
CURRENT		
Cash	\$ 122,070	\$ 147,082
Accounts receivable	2,214,593	2,296,919
Inventory	172,421	179,245
Prepaid expenses	189,112	206,786
	2,698,196	2,830,032
PROPERTY PLANT AND EQUIPMENT	2,934,822	3,178,743
INTANGIBLE ASSETS	2,130,575	2,857,372
GOODWILL	3,817,849	3,817,849
FUTURE INCOME TAXES	501,000	501,000
DEFERRED FINANCING COSTS, net of accumulated amortization	69,806	93,388
	\$ 12,152,248	\$ 13,278,384
LIABILITIES		
CURRENT		
Revolving loan	\$ 1,126,935	\$ 1,125,495
Accounts payable and accrued liabilities	2,320,145	2,357,494
Current portion long-term debt	381,024	532,620
Current portion of obligations under capital lease	107,404	106,370
	3,935,508	4,121,979
LONG-TERM DEBT	626,086	815,835
OBLIGATIONS UNDER CAPITAL LEASE	80,965	160,987
	707,051	976,822
REDEEMABLE PREFERRED SHARES	3,676,062	3,440,490
	4,383,113	4,417,312
SHAREHOLDERS' EQUITY		
COMMON SHARES	11,701,123	11,681,173
CONTRIBUTED SURPLUS	163,121	160,032
DEFICIT	(8,030,617)	(7,102,112)
	3,833,627	4,739,093
	\$ 12,152,248	\$ 13,278,384

See accompanying notes to consolidated financial statements. These interim financial statements should be read in conjunction with the 2005 annual consolidated financial statements.

On behalf of the Board of Directors:



 Charles H. Buehler, Director



 Matthew Gaasenbeek, Director

NATIONAL CHALLENGE SYSTEMS INC.
CONSOLIDATED STATEMENTS OF OPERATIONS AND DEFICIT
MONTH ENDED MARCH 31, 2006 AND 2005

	9 months ended March 31		3 months ended March 31	
	2006	2005	2006	2005
REVENUES				
Non hazardous vacuum services	\$ 11,592,808	\$ 10,079,027	\$ 3,909,163	\$ 3,596,484
Compactor rental income	388,504	388,504	129,501	129,501
Compactor sales, service & other	95,055	58,384	63,899	25,265
	12,076,367	10,525,915	4,102,563	3,751,250
DIRECT COSTS	9,238,068	7,866,055	3,209,621	2,790,369
CONTRIBUTION	2,838,299	2,659,860	892,942	960,881
OPERATING EXPENSE (INCOME)				
Cash operating expenses (income)				
Selling, general and administrative	2,204,766	1,865,763	766,409	604,099
Interest on long-term debt and obligations under capital lease	81,726	105,056	24,668	33,148
Other interest	68,607	35,754	27,595	11,945
	2,355,099	2,006,573	818,672	649,192
Non-cash operating expenses (income)				
Amortization of property, plant and equipment	438,272	435,475	148,721	144,425
Amortization of intangible assets	726,798	726,798	242,266	242,266
Settlement of liabilities through share issuance	25,000	104,695	-	16,000
Stock based compensation	3,089	5,976	-	-
Dividends on preferred shares	235,572	209,303	80,856	71,840
Foreign exchange gain	(17,026)	(54,267)	731	16,287
	1,411,705	1,427,980	472,574	490,818
TOTAL OPERATING EXPENSE	3,766,804	3,434,553	1,291,246	1,140,010
LOSS BEFORE OTHER INCOME (EXPENSE) AND INCOME TAXES	(928,505)	(774,693)	(398,304)	(179,129)
OTHER INCOME				
Gain on disposal property, plant and equipment	-	-	-	-
Recovery of investment	-	-	-	-
	-	-	-	-
LOSS BEFORE INCOME TAXES	(928,505)	(774,693)	(398,304)	(179,129)
INCOME TAXES (RECOVERY)				
Current	-	-	-	-
Future	-	-	-	-
	-	-	-	-
LOSS	(928,505)	(774,693)	(398,304)	(179,129)
DEFICIT, BEGINNING OF YEAR/QUARTER	(7,102,112)	(5,972,238)	(7,632,313)	(6,567,802)
DEFICIT, END OF YEAR/QUARTER	\$ (8,030,617)	\$ (6,746,931)	\$ (8,030,617)	\$ (6,746,931)
LOSS PER SHARE, BASIC AND DILUTED	\$(0.02)	\$(0.02)	\$(0.01)	\$(0.01)

See accompanying notes to consolidated financial statements. These interim financial statements should be read in conjunction with the 2005 annual consolidated financial statements.

NATIONAL CHALLENGE SYSTEMS INC.
CONSOLIDATED STATEMENTS OF CASHFLOWS
MONTH ENDED MARCH 31, 2006 AND 2005

	9 months ended March 31		3 months ended March 31	
	2006	2005	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:				
Net loss for the year	\$ (928,505)	\$ (774,693)	\$ (398,304)	\$ (179,129)
Add (deduct) items not involving cash				
Amortization of property, plant and equipment	438,272	435,475	148,721	144,425
Amortization of intangible assets	726,798	726,798	242,266	242,266
Dividends accrued on preferred shares	235,572	209,303	80,856	71,840
Settlement of liabilities through share issuance	25,000	104,695	-	16,000
Stock-based compensation	3,089	5,976	-	-
Foreign exchange (gain)/loss	(17,026)	(54,267)	731	16,287
	483,200	653,287	74,270	311,689
Changes in operating assets and liabilities:				
Decrease (increase) in accounts receivable, net	82,327	(495,157)	119,636	(304,703)
Decrease (increase) in inventory	6,825	(1,587)	3,134	7,743
Decrease (increase) in prepaid expenses	17,675	114,096	(24,296)	32,326
(Decrease) increase in accounts payable and accrued liabilities	(42,402)	75,885	222,267	25,606
Decrease in income taxes payable	-	(55,930)	-	(18,910)
CASH FLOWS FROM OPERATING ACTIVITIES	547,625	290,594	395,011	53,751
CASH FLOWS FROM INVESTING ACTIVITIES:				
Acquisition of property, plant and equipment	(166,255)	(989,087)	(58,629)	13,768
Proceeds on disposal of property, plant and equipment	-	-	-	-
	(166,255)	(989,087)	(58,629)	13,768
CASH FLOWS FROM FINANCING ACTIVITIES:				
Advance (repayment) of revolving loan	1,439	(216,094)	(168,248)	58,162
(Repayment) advance of long-term debt	(324,319)	400,820	(101,132)	(52,896)
(Repayment) advance of capital lease obligation	(78,988)	(73,029)	(26,848)	(73,110)
Payment of deferred financing costs	(4,514)	-	-	-
	(406,382)	111,697	(296,228)	(67,844)
DECREASE IN CASH DURING THE YEAR	(25,012)	(586,796)	40,154	(325)
CASH BEGINNING OF YEAR / QUARTER	147,082	596,086	81,916	9,615
CASH END OF YEAR / QUARTER	\$ 122,070	\$ 9,290	\$ 122,070	\$ 9,290
Supplemental cash flow information				
Interest paid	\$ 150,333	\$ 140,810	\$ 52,263	\$ 45,093
Income taxes paid		55,930		18,910

See accompanying notes to consolidated financial statements. These interim financial statements should be read in conjunction with the 2005 annual consolidated financial statements.

NATIONAL CHALLENGE SYSTEMS INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 March 31, 2006

1. NATURE OF OPERATIONS

National Challenge Systems Inc. (the “Company” or “NCS”) is incorporated under the Canada Business Corporations Act. The primary operations of the Company consist of operating vacuum truck fleets that provide collection, treatment and disposal services for non-hazardous liquid waste and other related services.

2. SIGNIFICANT ACCOUNTING POLICIES

These interim consolidated financial statements have been prepared in Canadian accordance with generally accepted accounting principles and follow the same accounting policies and method of application as the June 30, 2005 annual audited statements except that the interim consolidated financial statements do not conform in all respects with disclosure required for annual financial statements and should be read in conjunction with the annual consolidated financial statements for the year ended June 30, 2005.

3. CAPITAL STOCK

As per the employment contract of one of the executives, the Company at its option may elect to pay the employee in common shares. The number of shares is calculated by dividing the salary payable by \$0.15. The salary is based on an annual amount of \$120,000 pro-rated for the amount of time devoted to the Company. On July 27, 2005 the Company issued 133,000 common shares to the executive related to this contract.

	<u>Number of Shares</u>		<u>Book Value</u>	
	<u>9 Months Ended</u> <u>March 31, 2006</u>	<u>Year Ended</u> <u>June 30, 2005</u>	<u>9 Months Ended</u> <u>March 31, 2006</u>	<u>Year Ended</u> <u>June 30, 2005</u>
Opening balance	39,642,323	34,147,323	\$ 11,681,173	\$ 11,003,150
Directors' Compensation		145,000		18,523
Private Placement		5,040,000		613,000
Executive Compensation	133,000	310,000	19,950	46,500
Closing balance	39,775,323	39,642,323	\$ 11,701,123	\$ 11,681,173

4. COMPARATIVE FIGURES

Certain of the comparative figures have been reclassified to conform to the financial statement presentation adopted in the current year.