

NATIONAL CHALLENGE SYSTEMS INC.

Management Discussion and Analysis

Six Months Ended December 31, 2006

MANAGEMENT DISCUSSION & ANALYSIS

The following Management Discussion and Analysis (“MD&A”) is a discussion of the consolidated financial condition and results of operations of National Challenge Systems Inc. for the six-month period ended December 31, 2006. This discussion should be read in conjunction with the Unaudited Interim Consolidated Financial Statements of the Company and notes thereto for the six-months ended December 31, 2006, the MD&A for the year ended June 30, 2006 and the Audited Consolidated Financial Statements and notes thereto for the year ended June 30, 2006.

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

Revenue

The Company’s core greasetrap business recorded an increase in revenue of 7% during the first six months of fiscal 2007 compared to the same period last year. However, the Company’s two largest industrial accounts, both food processing facilities, significantly reduced their service levels after making capital improvements to their wastewater handling system to reduce the amount of residuals they produce. The vast majority of the Company’s customers do not have sufficient volumes of liquid organic waste to justify capital investments of this type and the lost revenue from these two industrial customers does not have a significant impact on the gross margin of the Company. In addition, the Company has been impacted by the labour shortage in Western Canada. The Vancouver operation has experienced a shortage of service technicians and as a result revenue in this market is down 8% for the first six months of this year over last year. The net impact on the overall revenue for the three months ended December 31, 2006 was a decrease of 4.9% or \$198,000 from \$4,008,000 in the second quarter of fiscal 2006 to \$3,810,000 in the second quarter of fiscal 2007. Year to date, revenue was down 4.0% or \$318,000 from \$7,974,000 in fiscal 2006 to \$7,656,000 in fiscal 2007.

Operating Results

The net loss of \$155,000 for the second quarter of fiscal 2007 was 49% or \$150,000 less than the net loss of \$305,000 for the same period last year. Year to date, the net loss was \$144,000, down 73% or \$386,000 from \$530,000 in fiscal 2006. The gross margin was up 27% or \$254,000 to \$1,199,000 for the second quarter of fiscal 2007 from \$945,000 for the same period last year. Year to date, gross margin was \$2,565,000, up 32% or \$622,000 from \$1,943,000 in fiscal 2006. As a percentage of revenues, gross margin was 31% in the second quarter of 2007 and 34% year to date, compared to 24% and 24% for the same periods last year, respectively.

Selling, general and administrative expenses were up \$83,000 or 12% from \$724,000 in the second quarter of fiscal 2006 to \$807,000 in the second quarter of fiscal 2007. Year to date, these expenses were \$1,644,000, 15% or \$208,000 higher than the \$1,436,000 recorded in fiscal 2006. This increase was the result of higher

banking, audit and legal fees as well as expenses related to the exploration and development of the Company's involvement in anaerobic digestion ("AD").

The Company's single largest operating expense, residuals management, was reduced significantly beginning in May 2006 as the Company was able to take more residuals to third-party recycling sites in Ontario instead of transporting them out of province. This situation changed in the second quarter of fiscal 2007 as the Ontario sites were impacted by colder weather and they reduced the volume of residuals they received. The Company has no long-term contracts with these third-party recycling sites and therefore cannot predict with certainty the volume of material they will receive. However, the Company's profitability can be materially impacted by the volume of residuals these Ontario sites receive.

The Company continues to have large non-cash operating expenses including amortization of intangible assets related to the acquisition of its two operating subsidiaries. The amortization of the intangible assets was \$242,000 in each of the first two quarters of 2006 and 2007. The Company has been amortizing intangible assets since 2003 and effective May 31, 2007, \$4,550,000 of these intangibles assets related to customers and software will be fully amortized. At that time only \$919,000 related to patent license agreements will remain. As a result, the quarterly amortization charge will be reduced from \$242,000 to \$25,000 beginning in June 2007 through to 2017.

<i>Non-Cash Expenses (in 000's)</i>	<u>Second Quarter</u>		<u>First Quarter</u>		<u>Fourth Quarter</u>		<u>Third Quarter</u>	
	<u>Ending Dec 31</u>		<u>Ending Sept 30</u>		<u>Ending June 30</u>		<u>Ending March 31</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Amortization of property, plant & equip	\$ 163	\$ 146	\$ 142	\$ 144	\$ 169	\$ 171	\$ 149	\$ 144
Write down of property, plant & equip	-	-	-	-	190	322	-	-
Gain on disposal property, plant & equip	-	-	(6)	-	-	-	-	-
Amortization of intangibles	242	242	242	242	242	242	242	242
Dividends accrued on preferred shares	88	78	86	76	83	74	81	72
Share based compensation	-	10	-	18	27	1	-	16
Foreign exchange (gain) loss	-	2	-	(19)	(6)	(6)	1	16
Future income taxes	-	-	-	-	(4)	(142)	-	-
	\$ 493	\$ 478	\$ 464	\$ 461	\$ 701	\$ 662	\$ 473	\$ 490

Quarterly Review

(in 000's except earnings per share)

	<u>Second Quarter</u>		<u>First Quarter</u>		<u>Fourth Quarter</u>		<u>Third Quarter</u>	
	<u>Ending Dec. 31</u>		<u>Ending Sep. 30</u>		<u>Ending Jun. 30</u>		<u>Ending Mar. 31</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Revenues	\$3,810	\$4,008	\$3,846	\$3,966	\$3,955	\$3,968	\$4,103	\$3,751
Net profit (loss)	(155)	(305)	11	(225)	(268)	(355)	(398)	(179)
Cash flows from operating activities	96	(237)	473	389	192	383	395	55
Profit (loss) per share, basic and fully diluted	0.00	(0.01)	0.00	(0.00)	(0.01)	(0.01)	(0.01)	(0.00)

In the third quarter of fiscal 2005, the Company increased rates to most Ontario customers in order to offset the erosion to the gross margin that had occurred from the increased cost of recycling organic residuals. Although revenue for fiscal 2006 increased by 11% over fiscal 2005, it was not sufficient to offset the increasing loss through the first three quarters of fiscal 2006 due to the higher costs of recycling. In the fourth quarter of fiscal 2006 this trend reversed as the revenue quality improved with additional rate increases and as disposal costs dropped with the Company's ability to take some of its waste to third-party facilities in Ontario. It is worthy of note also that the net loss for the fourth quarters of fiscal 2006 and 2005 included a

\$190,000 and \$322,000 write down of property, plant and equipment, respectively, both of which related to compactors. This write-down is a non-cash item.

The net profit of \$11,000 realized in the first quarter of fiscal 2007 continued the pattern of higher margins and lower disposal costs. The net loss of \$155,000 in the most recent quarter reflects an erosion of margin due to increased residuals disposal cost because more volume was trucked out of province.

Adjusted net earnings excluding non-cash expenses as displayed in the table below is a non-GAAP measure that does not have any standardized meaning prescribed by GAAP and is therefore unlikely to be comparable to similar measures presented by other issuers. It should not be construed as an alternative to net earnings or cash flow from operating activities determined in accordance with GAAP.

Adjusted net earnings excluding non-cash expenses is a measure of NCS' ability to earn cash and is intended to be a measure that is representative of NCS' operating performance. Adjusted net earnings excluding non-cash expenses appears on the Consolidated Statement of Cash Flows as a subtotal and is the sum of the net profit (loss) and items not involving cash.

Adjusted net earnings excluding non-cash expenses (in 000's)

	<u>Second Quarter</u>		<u>First Quarter</u>		<u>Fourth Quarter</u>		<u>Third Quarter</u>	
	<u>Ending Dec 31</u>	<u>2005</u>	<u>Ending Sept 30</u>	<u>2005</u>	<u>Ending June 30</u>	<u>2005</u>	<u>Ending March 31</u>	<u>2005</u>
Net profit (loss)	2006 \$ (155)	(305)	2006 \$ 11	(225)	2006 (268)	(355)	2006 (398)	(179)
Non-cash expenses	493	478	464	461	701	662	473	490
Adjusted net earnings excluding non-cash expenses	338	173	475	236	433	307	75	311
Changes in operating assets and liabilities	(242)	(410)	(2)	153	(241)	76	320	(256)
Cash flows from operating activities	\$ 96	\$ (237)	\$ 473	\$ 389	\$ 192	\$ 383	\$ 395	\$ 55

Balance Sheet & Cash Flow

Cash flows from operating activities for the three months ended December 31, 2006 improved by \$333,000, to a surplus of \$96,000 in fiscal 2007, from a shortfall of \$237,000 in the second quarter of fiscal 2006. The improvement was due to an increase in profitability but was moderated by a reduction in accounts payable of \$281,000. On a year to date basis, cash flows from operating activities were \$569,000 in fiscal 2007, an increase of \$417,000 compared to the same period in fiscal 2006, even though accounts payable were reduced by \$294,000.

Four new vacuum trucks were added to the fleet under capital leases in the quarter at a cost of \$511,000. Year to date, a total of five vehicles have been added at a cost of \$670,000. No trucks were added under a capital lease in the first six months of fiscal 2006.

The Company's revolving loan increased during the second quarter by \$297,000, with \$138,000 used to fund the net application of funds in the quarter and the balance representing a \$159,000 increase in the cash account. Year to date, the revolving loan decreased by \$60,000, from \$1,218,000 at June 30, 2006 to \$1,158,000 at December 31, 2006, and cash on hand increased by \$146,000, from \$227,000 to \$373,000.

STRATEGY

As previously reported NCS is exploring anaerobic digestion ("AD") as a potential recycling solution. 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.

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. A key goal of the SOP is to make anaerobic digestion for biogas energy production financially viable in Ontario and includes a long-term (20 year) fixed price contract. In November 2006 the Ontario Power Authority issued the final rules for the SOP and began accepting applications.

NCS has initiated contractual discussions with selected developers of AD projects in Ontario. These projects would produce biogas energy that qualifies under the SOP. 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.

RISKS & UNCERTAINTIES

The first two quarters of 2007 include the impact of a price increase to all the Ontario based customers. 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 continue to have a positive impact on the Company’s operating contribution, subject to the amount of lost business.

The Company is actively working on a number of potential AD sites that, if successfully funded, permitted and developed, would result in an Ontario in-province solution for the residuals the Company collects. This additional capacity would allow the Company to pursue a number of long-term contracts that it is unable to acquire today because of a lack of secure and competitively priced disposal options. The development of AD is subject to pending changes in government regulations for bringing off-farm waste (NCS’ residuals) onto a farm for co-digestion.

The Company has been forced to transport a large part of its Ontario residuals out-of-province in the last two years at increased cost. Beginning in May 2006 this changed and the Company began delivering the majority of its Ontario residuals to third-party sites in Ontario, thereby saving significant transportation costs. In the second quarter of fiscal 2007 this situation again changed as the Ontario sites reduced the volume of residuals they received. The Company has no long-term contracts with these third-party recycling sites and therefore cannot predict with certainty the volume of material they will continue to receive.

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)

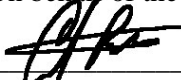
For the six months ended December 31, 2006

NATIONAL CHALLENGE SYSTEMS INC.
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

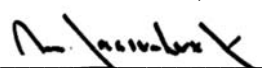
	DECEMBER 31	JUNE 30
	2006	2006
ASSETS		
CURRENT		
Cash	\$ 373,495	\$ 227,302
Accounts receivable	2,200,480	2,226,910
Inventory	153,369	151,667
Prepaid expenses	121,520	145,734
	<u>2,848,864</u>	<u>2,751,613</u>
PROPERTY PLANT AND EQUIPMENT	3,264,159	2,724,391
INTANGIBLE ASSETS	1,403,777	1,888,309
GOODWILL	3,817,849	3,817,849
FUTURE INCOME TAXES	505,000	505,000
DEFERRED FINANCING COSTS, net of accumulated amortization	43,779	60,441
	<u>\$ 11,883,428</u>	<u>\$ 11,747,603</u>
LIABILITIES		
CURRENT		
Revolving loan	\$ 1,157,613	\$ 1,217,865
Accounts payable and accrued liabilities	1,688,941	1,983,102
Current portion long-term debt	132,421	228,495
Current portion of obligations under capital lease	223,525	132,275
	<u>3,202,500</u>	<u>3,561,737</u>
LONG-TERM DEBT	642,392	670,940
OBLIGATIONS UNDER CAPITAL LEASE	612,591	119,220
	<u>1,254,983</u>	<u>790,160</u>
REDEEMABLE PREFERRED SHARES	3,933,475	3,759,343
	<u>5,188,458</u>	<u>4,549,503</u>
SHAREHOLDERS' EQUITY		
COMMON SHARES	11,743,933	11,743,933
CONTRIBUTED SURPLUS	190,513	190,380
DEFICIT	(8,441,976)	(8,297,950)
	<u>3,492,470</u>	<u>3,636,363</u>
	<u>\$ 11,883,428</u>	<u>\$ 11,747,603</u>

See accompanying notes to consolidated financial statements. These interim financial statements should be read in conjunction with the 2006 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
(UNAUDITED)

	6 MONTHS ENDED DECEMBER 31		3 MONTHS ENDED DECEMBER 31	
	2006	2005	2006	2005
REVENUES				
Non hazardous vacuum services	\$ 7,282,617	\$ 7,683,645	\$ 3,580,857	\$ 3,858,093
Compactor rental income	338,695	259,003	209,194	129,501
Compactor sales, service & other	34,326	31,157	19,671	19,910
	<u>7,655,638</u>	<u>7,973,805</u>	<u>3,809,722</u>	<u>4,007,504</u>
COST OF SALES	<u>5,090,887</u>	<u>6,030,888</u>	<u>2,610,391</u>	<u>3,062,270</u>
GROSS MARGIN	<u>2,564,751</u>	<u>1,942,917</u>	<u>1,199,331</u>	<u>945,234</u>
OPERATING EXPENSE (INCOME)				
Selling, general and administrative	1,643,684	1,435,917	807,113	723,906
Amortization of property, plant and equipment	304,762	289,551	162,457	145,688
Amortization of intangible assets	484,532	484,532	242,266	242,266
Share based compensation	133	28,089	133	10,333
Foreign exchange loss (gain)	453	(17,757)	0	1,624
	<u>2,433,564</u>	<u>2,220,332</u>	<u>1,211,969</u>	<u>1,123,817</u>
PROFIT (LOSS) BEFORE THE UNDERNOTED AND INCOME TAXES	131,187	(277,415)	(12,638)	(178,583)
OTHER INCOME AND EXPENSES				
Interest on long-term debt and obligations under capital lease	52,100	57,059	27,789	27,234
Other interest	54,566	41,011	25,749	20,818
Dividends on preferred shares	174,132	154,716	88,353	78,501
Gain on disposal property, plant and equipment	(5,585)	-	0	-
	<u>275,213</u>	<u>252,786</u>	<u>141,891</u>	<u>126,553</u>
LOSS BEFORE INCOME TAXES	(144,026)	(530,201)	(154,529)	(305,136)
INCOME TAXES	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
NET LOSS	(144,026)	(530,201)	(154,529)	(305,136)
DEFICIT, BEGINNING OF QUARTER / YEAR	(8,297,950)	(7,102,112)	(8,287,447)	(7,327,177)
DEFICIT, END OF QUARTER	\$ (8,441,976)	\$ (7,632,313)	\$ (8,441,976)	\$ (7,632,313)
LOSS PER SHARE, BASIC AND DILUTED	\$(0.00)	\$(0.01)	\$(0.00)	\$(0.01)

See accompanying notes to consolidated financial statements. These interim financial statements should be read in conjunction with the 2006 annual consolidated financial statements.

NATIONAL CHALLENGE SYSTEMS INC.
CONSOLIDATED STATEMENTS OF CASHFLOWS
(UNAUDITED)

	6 MONTHS ENDED DECEMBER 31		3 MONTHS ENDED DECEMBER 31	
	2006	2005	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:				
Net loss for the year	\$ (144,026)	\$ (530,201)	\$ (154,529)	\$ (305,136)
Add (deduct) items not involving cash:				
Amortization of property, plant and equipment	304,762	289,551	162,457	145,688
Amortization of intangible assets	484,532	484,532	242,266	242,266
Gain on disposal of property plant and equipment	(5,585)	-	-	-
Dividends accrued on preferred shares	174,132	154,716	88,353	78,501
Share based compensation	133	28,089	133	10,333
Foreign exchange loss (gain)	453	(17,757)	-	1,624
	814,401	408,930	338,680	173,276
Changes in operating assets and liabilities:				
Decrease (increase) in accounts receivable, net	26,430	(37,309)	23,367	(213,114)
Decrease (increase) in inventory	(1,702)	3,690	1,963	5,395
Decrease (increase) in prepaid expenses	24,215	41,971	12,541	(7,672)
Decrease in accounts payable and accrued liabilities	(294,162)	(264,668)	(280,786)	(194,544)
CASH FLOWS FROM OPERATING ACTIVITIES	569,182	152,614	95,765	(236,659)
CASH FLOWS FROM INVESTING ACTIVITIES:				
Acquisition of property, plant and equipment	(160,710)	(107,626)	(138,527)	(68,852)
Proceeds on disposal of property, plant and equipment	8,000	-	-	-
	(152,710)	(107,626)	(138,527)	(68,852)
CASH FLOWS FROM FINANCING ACTIVITIES:				
Advance (repayment) of revolving loan	(60,252)	169,687	296,861	444,183
Repayment of long-term debt	(125,075)	(223,187)	(48,808)	(99,041)
Repayment of capital lease obligation	(84,952)	(52,140)	(46,508)	(26,326)
Payment of deferred financing costs	-	(4,514)	-	-
	(270,279)	(110,154)	201,545	318,816
INCREASE (DECREASE) IN CASH DURING THE QUARTER/YEAR	146,193	(65,166)	158,783	13,305
CASH BEGINNING OF THE QUARTER / YEAR	227,302	147,082	214,712	68,611
CASH END OF QUARTER	\$ 373,495	\$ 81,916	\$ 373,495	\$ 81,916
Supplemental cash flow information				
Interest paid	\$ 106,667	\$ 98,070	\$ 53,538	\$ 48,052
Non-cash transactions				
Capital assets acquired through capital leases	669,573	\$ -	510,986	\$ -

See accompanying notes to consolidated financial statements. These interim financial statements should be read in conjunction with the 2006 annual consolidated financial statements.

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 accordance with Canadian generally accepted accounting principles and follow the same accounting policies and method of application as the June 30, 2006 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, 2006.

3. COMPARATIVE FIGURES

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