

NATIONAL CHALLENGE SYSTEMS INC.
Management Discussion and Analysis
Three Months Ended September 30, 2006

MANAGEMENT DISCUSSION & ANALYSIS

The following Management Discussion and Analysis (“MD&A”) dated November 14, 2006 is a discussion of the consolidated financial condition and results of operations of National Challenge Systems Inc. for the three-month period ended September 30, 2006. This discussion should be read in conjunction with: the Unaudited Interim Consolidated Financial Statements of the Company and notes thereto for the three-months ended September 30, 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

Revenue for the three months ended September 30, 2006 was down 3% or \$120,000 from \$3,966,000 in first quarter of 2006 to \$3,846,000 in the first quarter of 2007. The Company’s largest account, a food processing facility, significantly reduced their service for the first quarter of this year compared to last year, after making capital improvements to their wastewater handling system to allow them to reduce the amount of residuals they produce. The lost business had no impact on the gross margin of the Company. The vast majority of the Company’s customers do not have sufficient volumes of liquid organic waste to justify capital investments of this type.

Operating Results

Net profit for the first quarter of fiscal 2007 was up \$236,000 to \$11,000, from a loss of (\$225,000) for the first quarter of 2006. Gross margin was up 37% or \$367,000 to \$1,365,000 for the first quarter 2007 from \$998,000 for the first quarter 2006. As a percentage of revenues, the gross margin was 36% in the first quarter of 2007 compared to 25% in the first quarter of 2006.

Selling, general and administrative expenses were up \$125,000 or 17%, from \$712,000 in the first quarter of 2006 to \$837,000 in the first quarter of 2007. The increase was the result of increased 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 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 it out of province. This situation continued throughout the first quarter of 2007. The Company has no long-term contracts with these third party Ontario disposal sites and therefore cannot predict with certainty how long this situation will continue. However, the Company’s profitability will be materially and positively impacted for as long as it continues.

During the quarter the hourly employees at the Company’s Toronto operation represented by the Universal Workers Union Local 183 ratified their first collective agreement. The terms of the three year deal include a harmonization of pay scales over 24 months, improvements to benefits and a 3% wage increase in each of the three years. The agreement is effective October 1, 2006.

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 the first quarters of both 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 with only \$919,000 remaining related to patent license agreements. As a result, beginning in June 2007 the quarterly amortization charge will be reduced from \$242,000 to \$25,000 through to 2017.

<i>Non-Cash Expenses (in 000's)</i>	<u>First Quarter</u>		<u>Fourth Quarter</u>		<u>Third Quarter</u>		<u>Second Quarter</u>	
	<u>Ending Sept 30</u>		<u>Ending June 30</u>		<u>Ending March 31</u>		<u>Ending Dec 31</u>	
	<i>Fiscal Year</i>	<u>2007</u>	<u>2006</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>
Amortization of property, plant & equip	\$ 142	\$ 144	\$ 169	\$ 171	\$ 149	\$ 144	\$ 146	\$ 148
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	86	76	83	74	81	72	10	57
Share based compensation	-	18	27	1	-	16	78	70
Foreign exchange (gain) loss	-	(19)	(6)	(6)	1	16	2	(30)
Future income taxes	-	-	(4)	(142)	-	-	-	-
	\$ 464	\$ 461	\$ 701	\$ 662	\$ 473	\$ 490	\$ 478	\$ 487

Quarterly Review

Financial Information - Eight Quarter Summary (in 000's except earnings per share)

	<u>First Quarter</u>		<u>Fourth Quarter</u>		<u>Third Quarter</u>		<u>Second Quarter</u>	
	<u>Ending Sept 30</u>		<u>Ending June 30</u>		<u>Ending March 31</u>		<u>Ending Dec 31</u>	
	<i>Fiscal Year</i>	<u>2007</u>	<u>2006</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>
Revenues	\$3,846	\$3,966	\$3,955	\$3,968	\$4,103	\$3,751	\$4,008	\$3,446
Net profit (loss)	11	(225)	(268)	(355)	(398)	(179)	(305)	(299)
Cash flows from operating activities	473	389	192	383	395	55	(237)	30
Profit (loss) per share, basic and fully diluted	0.00	(0.00)	(0.01)	(0.01)	(0.01)	(0.00)	(0.01)	(0.01)

In the third quarter of fiscal 2005, the Company increased 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. As a result, the revenue for the second and third quarters of fiscal 2006 was 13% more than the revenue for the comparable two quarters in 2005.

The increasing loss through the first three quarters of fiscal 2006 reflects the ongoing increasing costs of recycling organic residuals. In the fourth quarter of 2006 this trend reversed as the revenue quality improved with additional rate increases and disposal costs dropped with the Company's ability to take some of its waste to third-party facilities in Ontario.

The \$268,000 net loss for the fourth quarter of 2006 was impacted by the \$190,000 (fourth quarter of 2005 - \$322,000) write down of property, plant and equipment, both of which were related to compactors. This is a non-cash item.

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>First Quarter</u>		<u>Fourth Quarter</u>		<u>Third Quarter</u>		<u>Second Quarter</u>		
	<u>Ending Sept 30</u>		<u>Ending June 30</u>		<u>Ending March 31</u>		<u>Ending Dec 31</u>		
	<i>Fiscal Year</i>	<u>2007</u>	<u>2006</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Net profit (loss)	\$	11	(225)	(268)	(355)	(398)	(179)	(305)	(299)
Non-cash expenses		464	461	701	662	473	490	478	487
Adjusted net earnings excluding non-cash expenses		475	236	433	307	75	311	173	188
Changes in operating assets and liabilities		(2)	153	(241)	76	320	(256)	(410)	(158)
Cash flows from operating activities	\$	473	\$ 389	192	\$ 383	395	\$ 55	(237)	\$ 30

Balance Sheet & Cash Flow

Cash flows from operating activities for the three months ended September 30, 2006 was up 21% or \$84,000 from \$389,000 in first quarter of 2006 to \$473,000 in the first quarter of 2007. The improvement was a direct result of the increase in profitability, but was moderated by the fact that last year there was a decrease in accounts receivable of \$176,000 compared to only a \$3,000 reduction this year.

The revolving loan was reduced by \$357,000 from \$1,218,000 at June 30, 2006 to \$861,000 at September 30, 2006.

During the quarter one new vacuum truck was added to the fleet under a capital lease. An additional five trucks are scheduled to be delivered during the second quarter of the current fiscal year with a total capital cost of approximately \$600,000.

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"). In addition, the Company intends to build on its strengths by developing compliance management software for 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.

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 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. 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 (20 year) fixed price contract. A key goal of the SOP is to make anaerobic digestion for biogas energy production financially viable in Ontario. In September 2006 the Ontario Power Authority issued draft rules for the SOP with a plan to allow application under the program beginning in November 2006.

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 produce 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 and Clean Water 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 of high energy liquid organics significantly boosts 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.

NCS has initiated contractual discussions with selected developers of AD projects in Ontario. 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. 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; which, in turn, increases the amount of electricity they generate.

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, the existing government regulations must be amended in order 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 co-digesting the Company’s residuals.

RISKS & UNCERTAINTIES

The first quarter of 2007 includes 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 2 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. However, the Company has no long-term contracts with these third party Ontario disposal sites and therefore cannot predict with certainty how long this situation will continue.

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)

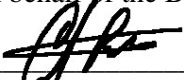
For the three months ended September 30, 2006

NATIONAL CHALLENGE SYSTEMS INC.
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

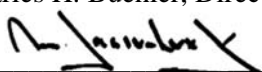
	SEPTEMBER 30	JUNE 30
	2006	2006
ASSETS		
CURRENT		
Cash	\$ 214,712	\$ 227,302
Accounts receivable	2,223,847	2,226,910
Inventory	155,333	151,667
Prepaid expenses	134,061	145,734
	2,727,953	2,751,613
PROPERTY PLANT AND EQUIPMENT	2,769,806	2,724,391
INTANGIBLE ASSETS	1,646,043	1,888,309
GOODWILL	3,817,849	3,817,849
FUTURE INCOME TAXES	505,000	505,000
DEFERRED FINANCING COSTS, net of accumulated amortization	51,075	60,441
	\$ 11,517,726	\$ 11,747,603
LIABILITIES		
CURRENT		
Revolving loan	\$ 860,752	\$ 1,217,865
Accounts payable and accrued liabilities	1,969,727	1,983,102
Current portion long-term debt	156,412	228,495
Current portion of obligations under capital lease	149,164	132,275
	3,136,055	3,561,737
LONG-TERM DEBT	667,210	670,940
OBLIGATIONS UNDER CAPITAL LEASE	222,473	119,220
	889,683	790,160
REDEEMABLE PREFERRED SHARES	3,845,122	3,759,343
	4,734,805	4,549,503
SHAREHOLDERS' EQUITY		
COMMON SHARES	11,743,933	11,743,933
CONTRIBUTED SURPLUS	190,380	190,380
DEFICIT	(8,287,447)	(8,297,950)
	3,646,866	3,636,363
	\$ 11,517,726	\$ 11,747,603

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)

	3 MONTHS ENDED SEPTEMBER 30	
	2006	2005
REVENUES		
Non hazardous vacuum services	\$ 3,701,760	\$ 3,825,552
Compactor rental income	129,501	129,501
Compactor sales, service & other	14,655	11,247
	3,845,916	3,966,300
COST OF SALES	2,480,495	2,968,617
GROSS MARGIN	1,365,421	997,683
OPERATING EXPENSE (INCOME)		
Selling, general and administrative	836,571	712,011
Amortization of property, plant and equipment	142,305	143,862
Amortization of intangible assets	242,266	242,266
Share based compensation	-	17,756
Foreign exchange loss (gain)	453	(19,380)
	1,221,595	1,096,515
PROFIT (LOSS) BEFORE THE UNDERNOTED AND INCOME TAXES	143,826	(98,832)
OTHER INCOME AND EXPENSES		
Interest on long-term debt and obligations under capital lease	24,312	29,825
Other interest	28,817	20,193
Dividends on preferred shares	85,779	76,215
Gain on disposal property, plant and equipment	(5,585)	-
	133,323	126,233
PROFIT (LOSS) BEFORE INCOME TAXES	10,503	(225,065)
INCOME TAXES	-	-
NET PROFIT/(LOSS)	10,503	(225,065)
DEFICIT, BEGINNING OF QUARTER	(8,297,950)	(7,102,112)
DEFICIT, END OF QUARTER	\$ (8,287,447)	\$ (7,327,177)
LOSS PER SHARE, BASIC AND DILUTED	\$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)

	3 MONTHS ENDED SEPTEMBER 30	
	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net profit (loss) for the year	\$ 10,503	\$ (225,065)
Add (deduct) items not involving cash:		
Amortization of property, plant and equipment	142,305	143,862
Amortization of intangible assets	242,266	242,266
Gain on disposal of property plant and equipment	(5,585)	-
Dividends accrued on preferred shares	85,779	76,215
Share based compensation	-	17,756
Foreign exchange loss (gain)	453	(19,380)
	475,721	235,654
Changes in operating assets and liabilities:		
Decrease in accounts receivable, net	3,063	175,804
Increase in inventory	(3,666)	(1,705)
Decrease in prepaid expenses	11,673	49,643
Decrease in accounts payable and accrued liabilities	(13,375)	(70,123)
CASH FLOWS FROM OPERATING ACTIVITIES	473,416	389,273
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of property, plant and equipment	(22,182)	(38,774)
Proceeds on disposal of property, plant and equipment	8,000	-
	(14,182)	(38,774)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of revolving loan	(357,113)	(274,496)
Repayment of long-term debt	(76,267)	(124,146)
Repayment of capital lease obligation	(38,444)	(25,814)
Payment of deferred financing costs	-	(4,514)
	(471,824)	(428,970)
DECREASE IN CASH DURING THE QUARTER	(12,590)	(78,471)
CASH BEGINNING OF THE QUARTER	227,302	147,082
CASH END OF QUARTER	\$ 214,712	\$ 68,611
Supplemental cash flow information		
Interest paid	\$ 53,129	\$ 50,018
Non-cash transactions		
Capital assets acquired through capital leases	\$ 158,587	\$ -

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.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 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, 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.