

MANAGEMENT'S DISCUSSION AND ANALYSIS

BASIS OF PRESENTATION

This Management's Discussion and Analysis ("MD&A") covers the interim consolidated financial statements for Westport Innovations Inc. ("Westport", "the Company", "we") for the three months ended June 30, 2006 and provides an update to our annual MD&A for the fiscal year ended March 31, 2006. This information is intended to assist readers in analyzing our financial results and should be read in conjunction with the audited annual consolidated financial statements, including the accompanying notes, for the fiscal year ended March 31, 2006 and our annual MD&A dated June 13, 2006.

Our consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). All financial information is reported in Canadian dollars unless otherwise noted.

This report contains forward-looking statements, including statements regarding the future success of our business and technology strategies and future market opportunities. These statements are neither promises nor guarantees, but involve known and unknown risks and uncertainties that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activities, performance or achievements expressed in or implied by these forward-looking statements. These risks include risks related to our revenue growth, operating results, industry and products as well as other factors discussed below and elsewhere in this report. Readers should not place undue reliance on any such forward-looking statements, which speak only as of the date they were made. We disclaim any obligation to publicly update or revise such statements to reflect any change in our expectations or in events, conditions or circumstances on which any such statements may be based, or that may affect the likelihood that actual results will differ from those set forth in the forward-looking statements.

Additional information relating to Westport, including our Annual Information Form, is available on SEDAR at www.sedar.com.

This management discussion and analysis is dated August 1, 2006.

FINANCIAL OVERVIEW

Comparing the three month period ending June 30, 2006 to the same period last year, our consolidated loss for the period was \$5.4 million, or \$0.07 per share, compared to \$6.2 million or \$0.08 per share, on total revenues of \$10.6 million and \$10.5 million respectively. We shipped 341 units in the quarter, up 31 from the same period last year and in US dollar terms, revenues were up 12%. However, this increase was offset by an 11% decline in the US dollar against the Canadian dollar. On the expense side, net research and development expenses increased by \$1.1 million, primarily because of lower government funding, while depreciation decreased by \$0.7 million. Cash used in operations before changes in working capital was \$3.7 million compared to \$3.0 million in the same period in the prior year. Cummins Westport Inc. ("CWI"), our 50:50 commercial joint venture with Cummins Inc. ("Cummins"), continued to perform well, contributing \$0.8 million in the quarter.

BUSINESS OVERVIEW

Westport's business operations and strategy are substantially unchanged from March 31, 2006. We are engaged in the research, development and marketing of high performance, low-emissions engine and fuel systems which use gaseous fuels such as natural gas, propane or hydrogen. Our strategy is to develop our technologies and products in cooperation with the world's leading engine and vehicle manufacturers and fuel infrastructure providers.

To date, we have established cooperative fuel system development programs with a number of automotive companies including Isuzu, Ford and BMW, and are in various stages of negotiations to develop and commercialize our technologies with Energy Developments Limited of Australia ("EDL" or "ENE"), Weichai Power Co. Ltd., and others. As at June 30, 2006, we had one commercial joint venture, CWI, with Cummins, a global power leader in engines, power generation and other related technologies. CWI leverages existing Cummins manufacturer facilities in North America, China and India to sell and market spark-ignited natural gas engines worldwide. As at June 30, 2006, we also held an approximate 6% investment interest in Clean Energy Fuels Corp., North America's largest provider of natural gas fuel and service infrastructure for vehicles.

On July 21, 2006, we signed a Joint Venture Agreement with Beijing Tianhai Industry Co. Ltd ("BTIC"), a Chinese-Korean company with its headquarters and manufacturing facilities in Beijing, China. The joint venture, BTIC Westport Inc. ("BWI"), will leverage BTIC's manufacturing expertise and Westport's liquefied natural gas (LNG) tank design to sell and market LNG tanks for natural gas fuelled vehicles globally. Through the 50:50 joint venture agreement and related license and supply agreements, BTIC and Westport will share equally in the profits on products developed and sold by the joint venture. BTIC and Westport will each contribute US\$0.4 million to the formation of the venture. Initiation of formal business operations is subject to customary government approvals. On July 24, 2006, we also announced the completion of a License and Supply Agreement with Cryostar SAS, a division of the BOC Group and a global leader in cryogenic pump products, for the development, manufacture and supply of cryogenic LNG fuel pumps, based on Westport's cryogenic technology. The off-engine LNG fuel system, consisting of the LNG fuel pump and LNG tank, is a critical component of the overall HPDI vehicle solution. These agreements form an integral part of Westport's strategy to secure long-term business alliances that will ensure a reliable supply of leading-edge, top quality components for our LNG transportation solutions, including our HPDI heavy duty LNG truck program.

Our Contribution Agreement with Technology Partnerships Canada ("TPC") ended March 31, 2006. However, we continue to work with TPC on extending this agreement to fund continued development of mine truck and light duty vehicle technologies on a retroactive basis to April 1, 2006. Discussions are proceeding and we continue to make progress claims to TPC. If and when an extension agreement is reached, we will reflect the accounting for the extension in the period formal notice is received.

In the three months ended June 30, 2006, we completed our year long Sustainable Development Technology Canada funded demonstration of our next-generation heavy-duty truck technology along Highway 401 in Ontario, dubbed the "Clean Air Corridor". Along with government, industry and infrastructure partners, we launched the five vehicle, one year demonstration in May 2005. The project successfully completed with 750,000 kilometers driven.

In the first quarter, we also announced two significant financial transactions, both of which are described more fully in the Capital Requirements, Resources and Liquidity section. On June 12, 2006, we agreed to issue up to \$22.1 million in 5 year secured, subordinated convertible notes with a coupon rate of 8% to Perseus, L.L.C. ("Perseus") of Washington, DC, a private equity fund management group. The notes are to be issued in two tranches of \$13.8 million and \$8.3 million, respectively. The first tranche is convertible to common shares at a conversion price of \$1.30 at any time during the term of the notes and the second tranche is convertible to common shares at a conversion price equal to \$1.40. At the time of issuance of the note, the noteholder also

receives warrants with a four year life to acquire, at an exercise price equal to the conversion price of the accompanying notes, common shares of Westport equal to 25% of the number of common shares into which the notes are convertible. The second tranche of \$8.3 million, the proceeds of which are to be used for a new business venture if certain milestones are met, is to be completed within 180 days of receiving shareholder approval, which was received on July 20, 2006.

On June 12, 2006, we issued \$5.5 million of the above referenced convertible notes and 1,062,115 warrants. On July 14, 2006, we received the balance of the first tranche and issued an additional \$8.3 million in convertible notes and 1,593,173 warrants.

On June 13, 2006, we also entered into an agreement with Matco Capital Ltd. ("Matco") to reorganize Westport Research Inc. ("WRI"), a wholly owned subsidiary of Westport. As part of the reorganization, we have substantially transferred all of the assets, liabilities and operations of WRI to another wholly owned Westport company which will carry on the business previously carried on by WRI. On closing, we anticipate selling 45% of the reorganized subsidiary to Matco for approximately \$4.0 million in cash consideration. In addition, Matco will facilitate access to a minimum non-recourse credit facility for at least \$7 million secured only by Westport's remaining shares in WRI. The transaction, which is substantially completed, was expected to close on or before July 31, 2006, but has been extended by mutual agreement to allow for finalizing the credit facility. We and Matco plan to source and pursue other opportunities to maximize the value of our respective interests in WRI.

We believe these two transactions, providing us with access to over \$32 million, provide us with the required capital to fund the commercialization of our technologies, including our heavy-duty truck program in North America, our mine truck initiatives in Australia, and our initiatives in China.

CRITICAL ACCOUNTING POLICIES

Financial statement preparation requires that we use estimates and assumptions that affect the reported amount of assets and liabilities as well as revenues and expenses. We have identified several policies as critical to the understanding of our business operations. The application of these and other policies are described in note 2 to our Fiscal 2006 annual consolidated financial statements with our critical accounting policies highlighted in our Fiscal 2006 annual MD&A.

We consider our accounting for CWI as a variable interest entity to be a critical accounting policy as CWI has a significant impact on our consolidated financials statements. We also consider the valuations of long-term investments, equipment, furniture and leasehold improvements, intellectual property, and inventory, and estimates of warranty liability to be critical accounting policies as they are subject to significant estimates and assumptions regarding valuation, future cashflows generated from existing assets, product quality and future warranty claims. Actual results may vary from these estimates. Our critical accounting policies are unchanged from March 31, 2006.

CHANGES IN ACCOUNTING POLICY

The accounting policies used in the unaudited consolidated interim financial statements for the three months ended June 30, 2006 are unchanged from the year ended March 31, 2006.

RESULTS FROM OPERATIONS

Product revenue for the three months ended June 30, 2006 generated from the sale of CWI spark-ignited natural gas engines increased to \$7.2 million from \$6.7 million in the same period last year primarily because of a 10% increase in units shipped and product mix. In US dollar terms, product revenues increased 21% but this increase was offset by an 11% depreciation in the US dollar. Non-CWI revenues increased by \$0.1 million to \$0.4 million, bringing total consolidated product revenue to \$7.6 million compared to \$7.0 million in the prior year.

Revenue		
<i>Expressed in thousands of Canadian dollars</i>		
	Three months ended June 30	
	2006	2005
Engine shipments (units)	341	310
Product revenue	7,644	7,006
Parts revenue	2,978	3,508
	<u>10,622</u>	<u>10,514</u>

Product Revenue by Geographic Region		
<i>As a percentage of revenue dollars</i>		
	Three months ended June 30	
	2006	2005
	(unaudited)	(unaudited)
North America	72%	75%
China	6%	9%
Rest of the world	22%	16%

Parts revenue for the three months ended June 30, 2006 compared to June 30, 2005 decreased to \$2.9 million from \$3.5 million as a result of change of mix in parts sold and the decline in the US dollar.

Cost of revenue for the three months ended June 30, 2006 was \$6.6 million compared to \$7.8 million in the same period last year, primarily reflecting lower warranty accruals (\$0.5 million) and the lower US dollar (\$0.8 million). Cost of revenue includes unit production cost and the associated warranty as well as the cost of parts sold.

Gross profit increased to \$4.0 million from \$2.7 million on product mix and lower warranty accruals. Gross margin percentage increased from 26% in the three months ended June 30, 2005 to 38% in the three months ended June 30, 2006, consistent with lower warranty accruals and the sale of higher horsepower and higher priced product.

Research and development expenses, on a net basis, for the three months ended June 30, 2006 were \$6.0 million compared to \$4.9 million for the same period last year. The \$1.1 million increase in spending is primarily the result of higher gross research and development spending for HPDI on-engine and off-engine systems such as the LNG tank and pump in preparation for

licensing and commercialization and an accrual for \$0.3 million in TPC royalty payments, offset by a decrease in stock-based compensation of \$1.3 million. On the government funding side, government funding decreased with the expiration of the TPC funding agreement (\$0.6 million) and with the substantial completion of the South Coast Air Quality Management District and NREL funded 1.2 gram heavy duty truck project. CWI research and development costs were up \$0.4 million primarily reflecting lower government funding.

General and administrative expenses were down \$0.1 million to \$1.4 million for the three months ended June 30, 2006 primarily due to timing of expenses.

Sales and marketing expenses decreased by \$0.3 million to \$1.0 million from \$1.3 million for the three months ended June 30, 2006 compared to the same period last year. CWI sales and marketing expenses were relatively flat year over year. However, non-CWI sales and marketing decreased by \$0.3 million primarily because of lower stock-based compensation expense in the quarter and timing of expenditures.

Foreign exchange gain of \$0.1 million primarily reflects the realized net gains on foreign currency transactions and the net unrealized gains on our net US dollar denominated liabilities, which is mainly comprised of warranty. The Canadian dollar strengthened by approximately 5% from March 31, 2006 to June 30, 2006 and weakened by 1% for the same period in the prior year.

Depreciation and amortization decreased to \$0.3 million from \$1.1 million primarily as the result of certain intellectual property, equipment and furniture becoming fully amortized as of March 31, 2006 and as the result of our change in our estimates of the useful life of our research and development machinery and equipment from five to eight years in the second quarter of fiscal 2006.

Joint Venture Partner's share of income from joint venture reflects Cummins' 50% share of CWI net operating contribution in the period.

CAPITAL REQUIREMENTS, RESOURCES AND LIQUIDITY

As at June 30, 2006, our cash, cash equivalents and short-term investment position was \$8.8 million.

In the first quarter, we announced two significant financial transactions. On June 12, 2006, we agreed to issue up to \$22.1 million in 5 year secured, subordinated convertible notes with a coupon rate of 8% to Perseus of Washington, DC, a private equity fund management group. The notes are to be issued in two tranches of \$13.8 million and \$8.3 million, respectively with the first tranche having been completed. Starting December 31, 2006, interest will be payable semi-annually in arrears, on June 30 and December 31, in additional notes or shares, at our option, for the first two years. After the first two years, interest will be calculated at a rate of 8% on the outstanding principal amount only for the number of trading days in the period on which the share price is below \$3.00 and is payable semi-annually in cash, additional convertible notes or shares at our option. The first tranche is convertible to common shares at a conversion price of \$1.30 at any time during the term of the notes and the second tranche is convertible to common shares at a conversion price equal to \$1.40. At the time of issuance of the note, the noteholder also receives warrants to acquire, at an exercise price equal to the conversion price of the accompanying notes, common shares of Westport equal to 25% of the number of common shares into which the notes are convertible. The term to expiry of the warrants is four years from the date of issuance and the warrants include a cashless exercise provision which would allow the noteholder to receive the number of common shares having a value equal to the net gain that would be realized by the noteholder had the warrant been exercised for cash and the related shares sold at the market price on the date the option is exercised. Any warrants under the cashless exercise provision converted will be cancelled. For so long as Perseus continues to

hold notes and warrants convertible into a specified percentage of Westport's issued and outstanding shares, Perseus will also be entitled to nominate two of seven board seats. The notes will be secured with a second charge on all of our assets.

\$5.5 million of the first tranche of the \$13.8 million was received on June 12, 2006 and the balance of \$8.3 million received on July 14, 2006. The second tranche of \$8.3 million, the proceeds of which are to be used for a new business venture if certain milestones are met, is to be completed within 180 days of receiving shareholder approval, which was received on July 20, 2006.

	Issuance Date	Principal - CDN	Conversion Price	No. of shares	No of warrants
Tranche 1					
Initial Closing	12-Jun-06	5,523,000	1.30	4,248,462	1,062,115
Interim Closing	14-Jul-06	8,284,500	1.30	6,372,692	1,593,173
Total outstanding as of July 31, 2006		13,807,500	1.30	10,621,154	2,655,288
Tranche 2					
	Not yet issued	8,284,500	1.40	5,917,500	1,479,375
Total of Tranche 1 and 2		22,092,000		16,538,654	4,134,663

On June 13, 2006, we also entered into an agreement with Matco Capital Ltd. ("Matco") to reorganize Westport Research Inc. ("WRI"), a wholly owned subsidiary of Westport. As part of the reorganization, we have substantially transferred all of the assets, liabilities and operations of WRI to another wholly owned Westport company which will carry on the business previously carried on by WRI. Our reorganization is substantially completed and we expect to sell a 45% equity interest in WRI to Matco for approximately \$4.0 million in cash on closing. Matco will also facilitate access to a non-recourse loan of at least \$7.0 million. The loan will be interest bearing until December 31, 2006, after which Westport will have no further interest obligations.

We also have a \$13 million credit facility with our bank, which has been drawn down by our demand instalment loan of \$2.2 million, capital leases of \$0.3 million, and a \$0.6 million letter of credit. We have also relied on public and private sources of equity financing to fund our operations. Since our incorporation in 1995, we have raised over \$230 million in common share equity primarily from a number of private and public offerings.

During the three months ended June 30, 2006, we issued \$5.5 million in convertible notes, used \$3.7 million in operations, \$0.3 million in loan repayments, and \$0.2 million for the purchase of equipment, furniture and leasehold improvements. As part of our financing transactions with Perseus and Matco, we have incurred approximately \$0.4 million in deferred financing costs to June 30, 2006 which will be expensed over the term of the Perseus convertible notes or in the period the Matco transaction completes, as applicable.

We believe that our current cash, cash equivalents and short-term investments, our investment in Clean Energy and the transactions with Perseus and Matco provide us with sufficient capital to meet our committed milestones and obligations for our current programs. Our capital requirements will vary depending on a number of factors, including the contributions from the sales of products and parts, progress of our current programs, any decisions by us and our current engine partners to enter into new program phases and any decision by us to establish additional programs or strategic alliances. In addition, we review investment and acquisition opportunities on a regular basis for technologies, businesses and markets that would complement our own products or assist us in our commercialization plans.

Significant new or expanded engine programs, acquisitions or investments could require additional funding. If such additional funding is not available to us, or if we have significant overspending in our programs, we may be required to delay, reduce or eliminate certain research and development activities and possibly forego new program, acquisition or investment opportunities. Any of those circumstances could potentially result in a delay of the commercialization of our products in development.

CONTINGENT OFF-BALANCE SHEET ARRANGEMENTS

Commitments and contingencies have been disclosed in our annual MD&A dated June 13, 2006 and are substantially unchanged. As at June 30, 2006, we have accrued \$0.3 million in TPC royalty payments pursuant to our Contribution Agreement with them.

Under our signed joint venture agreement with BTIC, we are committed to contributing US\$0.4 million to the formation of the venture. Initiation of formal business operations is subject to customary government approvals.

SHARES OUTSTANDING

For the three months ended June 30, 2006, the weighted average number of shares used in calculating the loss per share was 74,635,499. Actual shares outstanding as of June 30, 2006 was 74,949,385 with 1,062,115 warrants outstanding, 4,926,647 share options outstanding at a weighted average price of \$2.03 and 1,483,159 performance share units outstanding. Of the share options outstanding, 1,511,625 were exercisable at a weighted average price of \$3.18. Of the performance share units outstanding, 1,083,160 were exercisable. As of August 1, 2006, we had 75,264,565 shares outstanding, 2,655,288 warrants outstanding, 4,934,352 options outstanding at a weighted average price of \$1.99 and 2,083,159 of performance share units outstanding of which 1,183,162 were exercisable. We also had convertible notes of \$13.8 million outstanding with a conversion price of \$1.30.

SELECTED QUARTERLY FINANCIAL DATA (unaudited)

The selected table provides summary financial data for our last eight quarters:

Selected Quarterly Operations Data (Unaudited)									
Three months ended	30-Sep-04	31-Dec-04	31-Mar-05	30-Jun-05	30-Sep-05	31-Dec-05	31-Mar-06	30-Jun-06	
Units shipped	152	328	445	310	384	245	388	341	
Average foreign exchange rate (C\$:US\$)	\$ 1.30	\$ 1.20	\$ 1.23	\$ 1.24	\$ 1.19	\$ 1.17	\$ 1.15	\$ 1.11	
<i>(Expressed in thousands of Canadian dollars except per share)</i>									
Product revenue	\$ 3,617	\$ 7,031	\$ 8,532	\$ 7,006	\$ 9,095	\$ 5,147	\$ 8,684	\$ 7,644	
Parts revenue	\$ 2,364	\$ 2,211	\$ 1,857	\$ 3,508	\$ 3,134	\$ 3,466	\$ 3,512	\$ 2,978	
Total revenue	\$ 5,981	\$ 9,242	\$ 10,389	\$ 10,514	\$ 12,229	\$ 8,613	\$ 12,196	\$ 10,622	
Cost of sales	\$ 4,205	\$ 5,693	\$ 7,339	\$ 7,804	\$ 7,934	\$ 4,933	\$ 7,971	\$ 6,585	
Gross margin	\$ 1,776	\$ 3,549	\$ 3,050	\$ 2,710	\$ 4,295	\$ 3,680	\$ 4,225	\$ 4,037	
	30%	38%	29%	26%	35%	43%	35%	38%	
Loss for the period	\$ 5,837	\$ 4,156	\$ 9,308	\$ 6,213	\$ 3,329	\$ 3,607	\$ 3,711	\$ 5,420	
Basic and diluted loss per share ⁽¹⁾	\$ 0.09	\$ 0.06	\$ 0.12	\$ 0.08	\$ 0.05	\$ 0.05	\$ 0.05	\$ 0.07	
Cash used in operations before change in non-cash working capital	\$ 3,713	\$ 2,105	\$ 3,100	\$ 3,019	\$ 1,463	\$ 2,225	\$ 1,954	\$ 3,685	
Company's 100% share of CWI loss (income), excluding foreign exchange	\$ 1,126	\$ (1,314)	\$ (233)	\$ (211)	\$ (1,251)	\$ (517)	\$ (1,099)	\$ (1,351)	
Joint Venture Partner's share of CWI	\$ -	\$ -	\$ (69)	\$ (66)	\$ (758)	\$ (251)	\$ (518)	\$ (764)	

⁽¹⁾ Fully diluted loss per share is not materially different as the effect of stock options, warrants and performance share units would be anti-dilutive.

Our quarterly results are impacted by the timing of product deliveries, completion of engineering milestones, government and partner funding and foreign exchange gains and losses. CWI income or loss, and our resulting 50% share, will vary from quarter to quarter depending on the timing of unit sales, product and customer mix, and the timing of completion of engineering milestones and related government funding.

RISKS AND UNCERTAINTIES

Business risks and uncertainties related to product development, competitive and regulatory environments, economic and industry factors are described in detail in our fiscal 2006 MD&A and referenced in our 2006 Annual Information Form. They remain substantially unchanged.