

2006 Second Quarter Report



Three months and six months ended June 30, 2006

(Unaudited)

RAILPOWER TECHNOLOGIES CORP.

Management's Discussion and Analysis

For the three months and six months ended June 30, 2006

Montréal, August 14, 2006

Management's Discussion and Analysis (MD&A) relates to the financial condition and results of the operations of Railpower Technologies Corp. for the three months (the "Quarter") and six months (the "Six-Month Period") ended June 30, 2006. Throughout this MD&A, "Railpower", "we", "us", "the Company" and "our" refer to Railpower Technologies Corp. and to its wholly owned US subsidiary Railpower Hybrid Technologies Corp.

Railpower's common shares are listed on the Toronto Stock Exchange under the symbol "P". All financial information reflected herein was determined on the basis of Canadian generally accepted accounting principles (GAAP). This interim MD&A should be read in conjunction with Railpower's unaudited interim consolidated financial statements for the three months and six months ended June 30, 2006 and notes thereto as well as with Railpower's audited consolidated financial statements for the year ended December 31, 2005, notes thereto and corresponding annual MD&A.¹

Unless specifically stated otherwise, all dollar amounts in this MD&A are in Canadian dollars and the information herein is given as of the date of this MD&A.

OUR BUSINESS

Railpower is engaged in the development, production, marketing and sales of specialized energy technology systems for transportation. Our origins and initial focus are in railroad applications. However, our technologies have broader potential and applications in other markets and industries.

We have designed and are marketing a range of locomotives for the North American low horsepower (under 2,500 hp) locomotive markets: our GG-series (Green Goat®) yard switching locomotives and our RP-series road switcher locomotives. We also work with international partners to adapt our technology to suit the special needs of their markets.

Our GG-series yard switching locomotives achieve fuel savings in the order of 40 to 70% while cutting smog precursor oxides of nitrogen ("NOx") and particulates by 80 to 90% when compared to conventional switching locomotives in the 1,000 to 2,500 horsepower range. Our RP-series road switchers are projected to achieve fuel savings of approximately 20% to 40% while cutting NOx and particulate emissions by approximately 80% when compared to conventional road switcher locomotives.

Our locomotives are produced by converting existing conventional diesel-electric locomotives. Our current focus is the production and delivery of our locomotives to our customers in North America and the finalization of the designs and assembly of our pre-production road switcher locomotives ahead of our anticipated move into commercial production of road switcher locomotives later in 2006.

Overview: We are transforming Railpower from an R&D and low-volume production operation to a large-scale locomotive manufacturer. This evolution requires people, processes, a strong supply chain and time. In addition to strengthening our supply chain, we are working to lowering our total locomotive production costs, which will be an ongoing effort.

Sales and Marketing: As of June 30, 2006, we had firm orders for 150 locomotives. No additional locomotive orders were received during the Quarter. However, subsequent to the Quarter end, we announced a new order from Norfolk Southern for two RP20BD kits for delivery in 2006, bringing our

¹ Our 2005 annual report can be found on our website at www.railpower.com or on www.sedar.com

order backlog to 152 units. The order includes an option for additional orders from 2007 to 2009. We are currently in discussions with several Class I railroads with respect to their strategic plans for their low horsepower locomotive fleets. These customers are eager to test our RP-series demonstration units as soon as they are ready.

Outside of North America, our first hybrid yard switcher was completed by Swedish Train Technology ("STT") in Sweden during the Quarter. This unit will be on display at the largest European rail trade fair, Innotrans this fall. We expect to begin customer demonstrations with this locomotive in 2006 following a testing period.

Production: Our business model is to subcontract the assembly of our locomotives to established locomotive manufacturers. We do not own these facilities.

Production activities during the Quarter were distributed among our three main locomotive assembly subcontractors:

1. Super Steel Schenectady, Inc. ("Super Steel"), Glensville, New York.
2. Alstom Inc. ("Alstom"), Calgary, Alberta.
3. Canadian Allied Diesel Co. Ltd ("CAD"), Montreal, Quebec.

Production during the Quarter also occurred at Railserve, Inc. in Longview, Texas. Railserve purchases locomotive "kits" that they are assembling at their facility under Railpower's supervision.

Thirteen locomotives were produced during the Quarter. As explained in our news release on July 6, 2006 regarding our update on our business outlook, we have reduced our production forecast for 2006 to a range of 50 to 65 locomotives. In order to finalize design details and subsequent procurement of material, we had to revise our production schedule.

Of the thirteen units produced, three were sold; three were produced and considered finished goods but are subject to a conditional sales contract; five units were produced and were in transit or leased at the end of the quarter; and two units were demonstration units. The first demonstration unit was built in Sweden in conjunction with our licensee Swedish Train Technology. As per the license agreement, this unit is the property of Swedish Train Technology. The other demonstration unit is our RP20BD demonstrator currently in Schenectady, New York. We have delayed the release of the units for customer trials pending the completion of some modifications. Shortly after the end of the Quarter, testing of the first RP20BD for Union Pacific's order for 98 road switchers commenced, which we expect to last for 7 weeks.

Research and Development: During the Quarter, we finalized the detailed design of our Generation III GG20B locomotive. We have commitments to deliver more than 30 of those units through our three subcontractors and an additional eight units to be assembled at Railserve from kits they purchased from us.

We also made significant progress in the engineering of our RP-series road switchers. We expect to complete the demonstration RP20BH model (two engine battery hybrid) prototype in the fourth quarter of 2006.

SECOND QUARTER 2006 VS SECOND QUARTER 2005 AND SIX-MONTH PERIOD ENDED JUNE 30, 2006 VS SIX-MONTH PERIOD ENDED JUNE 30, 2005

Financial Overview

During the Quarter, our net loss increased to \$15,247,637 from \$6,852,962 in the corresponding quarter of 2005. During the Six-Month Period, our net loss increased to \$23,920,590 from \$12,177,414 in the corresponding period of 2005. These increases in the net loss were caused by an increase in our operating expenses amounting to \$4,018,302 for the Quarter and \$6,804,266 for the Six-Month Period to support larger manufacturing levels and by an increase in the provision for future contract losses.

In the Quarter we recorded an increase in the provision for future contract losses amounting to \$5,698,474 (\$6,569,626 for the Six-Month Period) based on our revised estimates for labor, material costs and overhead expenses due to engineering delays and continuous production and quality issues associated with these contracts. This provision will be reviewed on a quarterly basis and may be adjusted in the future. See "Provisions for Warranties, Future Contract Losses and Development Costs" below.

As at June 30, 2006, the number of employees and consultants was 153 compared to 81 as at June 30, 2005.

Sales

Sales for the Quarter were \$2,712,837 compared to \$4,010,733 for the corresponding quarter of 2005 and sales for the Six-Month Period were \$4,972,227 compared to \$4,010,733 for the same period in 2005.

In the Quarter, we completed the sale of three locomotives for a total of six for the Six-Month Period. In 2005, five sales were completed, all in the second quarter.

Cost of Goods Sold

Cost of goods sold in the Quarter was \$4,991,255 compared to \$6,105,612 in the second quarter of 2005 while cost of goods sold in the Six-Month Period was \$9,470,091 compared to \$6,782,099 for the same period in 2005. The amounts for the Quarter and the Six-Month Period reflect the sale of three and six locomotives in 2006, respectively, compared to five locomotives sold during the second quarter of 2005. The increase is also due to the increase in the allocation of manufacturing overhead expenses. This allocation amounted to \$2,304,989 for the Quarter and \$4,391,444 for the Six-Month Period compared to \$969,350 and \$1,645,837 for the corresponding periods in 2005, respectively. The largest increases in the overhead allocation came in salaries and brokerage and freight, partially offset by a reduction in consulting costs. The production level that we reached in 2006 required more manufacturing support, supervision and procurement activities.

Our costs of production exceeded our sales revenue during the Quarter and the Six-Month Period. We are continuing our efforts to reduce both the costs of components in our locomotives and the costs of assembly. We have not yet had sufficient volume production of a single locomotive model to gain the efficiencies available from volume purchasing discounts and from long production runs. We expect that the current order book and anticipated production rate will enable us to produce locomotives at decreasing unit costs and generate positive manufacturing margins.

Provisions for Warranties, Future Contract Losses and Development Costs

	June 30, 2006	December 31, 2005
<u>Current portion</u>		
Warranty provision	\$ 474,809	\$ 318,563
Provision for future contract losses	4,648,691	10,988,707
Provision for development costs	-	300,000
<u>Long-term portion</u>		
Warranty provision	3,545,956	4,783,955
Provision for future contract losses	18,904,237	12,029,664
	\$ 27,573,693	\$ 28,420,889

As at December 31, 2005, the Company had a provision of \$28,420,889 for warranties, future contract losses and development costs related to the Company's GG-series hybrid yard switcher locomotive models.

(a) Current portion of warranty provision

The current portion of warranty provision represents the expected costs of the general warranty for the next twelve months on each locomotive that has been sold at June 30, 2006. This provision is based on historical data and expectations from management and depends on the number of locomotives sold that are still under warranty.

(b) Warranty provision

The Company recorded in December 2005 an amount of \$4,783,955 in additional warranty costs for future battery pack replacements and generator set ("genset") upgrades on sold GG20B series locomotives.

During the quarter ended March 31, 2006, we have launched an equipment inspection program. The information obtained from this program as well as additional operating data gathered from our units in service and further analysis of that data have allowed us to better understand all factors affecting battery life. We have also modified the final design for the Generation III GG20B locomotive to further improve battery life. As a result, we estimated that we would incur lower warranty costs and, therefore, we had decreased the provision by \$1,105,545 as at March 31, 2006.

As at June 30, 2006, the provision was reviewed by management and technical specialists and, as a result, it was concluded that no changes were required to the provision when compared to the March 31, 2006 provision. The variation of the provision in the three months ended June 30, 2006 is only due to the exchange rate fluctuation during these periods.

(c) Provision for future contract losses

As at December 31, 2005, the estimate for future contract losses amounted to \$23,018,371. This provision was decreased by \$1,558,932 as at March 31, 2006 and increased by \$2,093,489 as at June 30, 2006 as explained below:

<u>Balance as at December 31, 2005</u>		
Current portion	\$	10,988,707
Long term portion		<u>12,029,664</u>
		<u>\$ 23,018,371</u>
Actual costs incurred during the first quarter of 2006		
		(2,430,084)
Effect on the first quarter of 2006 operations		
Increase in provision	\$	4,591,931
Reversal - Battery replacement		(3,839,169)
Loss on new contract		<u>118,390</u>
		<u>871,152</u>
<u>Balance as at March 31, 2006</u>		
Current portion		11,729,390
Long term portion		<u>9,730,049</u>
		<u>\$ 21,459,439</u>
Actual costs incurred during the second quarter of 2006		
		(3,549,867)
Effect on the second quarter of 2006 operations		
Increase in provision	\$	5,698,474
Foreign exchange rate impact		<u>(55,118)</u>
		<u>5,643,356</u>
<u>Balance as at June 30, 2006</u>		
Current portion	\$	4,648,691
Long term portion		<u>18,904,237</u>
		<u>\$ 23,552,928</u>

During the three months ended March 31, 2006, we completed a review of the contracts using new data obtained from our manufacturing sites and from units in service as discussed above. Based on this review and actual data collected during the first quarter of 2006, we increased our estimate of the provision for future contract losses to account for additional labour and material costs and reduced the provision for battery replacement based on the estimated extended battery life previously disclosed.

This review was also conducted as at June 30, 2006 using the most recent data available from completed Generation III GG20B locomotives at the end of the quarter. As a result, we increased our estimate for future contract losses by \$5,643,356 to reflect increases in labor, material costs and manufacturing overhead expenses anticipated to be incurred in completing the contracts due to continuous production and quality issues and engineering problems.

Management is actively working on a plan to mitigate losses related to this provision.

(d) Provision for development costs

A provision amounting to \$300,000 was recorded in accounts payable and accrued liabilities at December 31, 2005 for the development costs of the third generation of the GG20B model. During the three months ended June 30, 2006, the project was completed and the expenses incurred were applied against the provision.

Selling Expenses

Selling expenses for the Quarter and for the Six-Month Period were \$391,509 and \$858,265, respectively, compared to \$359,412 and \$669,710 for the corresponding periods of 2005, respectively, due to a higher level of activities in 2006.

Service Expenses

Service expenses for the Quarter and for the Six-Month Period were \$1,357,990 and \$3,005,924, respectively, compared to \$851,701 and \$1,282,500 for the corresponding periods of 2005, respectively. The largest increases came in salaries, inspection costs and repairs and maintenance.

With manufacturing underway, the number of our locomotives in the field increased to 44 as at June 30, 2006 compared to 12 as at June 30, 2005. The increase in our fleet required more support and service to our customers.

We completed the inspection program that was launched on January 26, 2006 on all Generation I and Generation II GG-series locomotives. During this inspection, we found that a number of these locomotives must undergo more thorough modifications. This campaign is in process and is expected to be completed during the third quarter. The total amount incurred in relation to these inspections as at June 30, 2006 amounted to \$869,000 of which \$230,000 were incurred during the second quarter of 2006.

Engineering and Research and Development

Engineering and research and development expenses for the Quarter and for the Six-Month Period were \$2,949,694 and \$5,598,725, respectively, compared to \$2,052,400 and \$4,555,783 for the corresponding periods of 2005, respectively. The largest increases came in salaries, consulting and travel partially offset by decreases in re-engineering costs.

The engineering department expanded during 2006 and maintained a high level of activity to complete the design of the Generation III GG20B and to continue development on the RP-series locomotives. We anticipate that this level of activity will decrease over time.

In the second quarter of 2005, a write-down of \$743,382 for the early production units was recorded for a total amount of \$2,283,734 for the six months ended June 30, 2005. In 2006, no provision of this nature was recorded resulting in a favorable impact partially offsetting the additional expenses described above.

General and Administrative

General and administrative expenses for the Quarter and for the Six-Month Period were \$2,670,569 and \$4,997,428, respectively, compared to \$1,850,949 and \$3,337,602 for the corresponding periods of 2005, respectively. The largest increases in expenditures occurred in consulting, salaries, stock-based compensation, travel and recruitment. These increases were driven by the addition of consultants and permanent employees required to support larger manufacturing levels.

Interest Income

Interest income amounted to \$521,833 for the Quarter and to \$1,178,026 for the Six-Month Period compared to \$288,520 and \$609,112 for the corresponding periods in 2005, respectively. These increases reflect the higher cash balances in 2006.

Exchange Rate Impact

We record monetary items denominated in foreign currencies using the temporal method under which items are translated to Canadian dollars at the rate in effect on the balance sheet date.

We report our results in Canadian dollars. As we purchase many of the components for our locomotives and pay in U.S. dollars, there is the potential for a gain or loss on the amount owing in U.S. dollars. During the Quarter and the Six-Month Period, we had a net gain of \$309,769 and \$351,288, respectively, compared to \$329,922 and \$265,413, respectively, principally from the value of amounts due in U.S. dollars decreasing as the Canadian dollar rose in relation to the U.S. dollar. Also, at the end of the Quarter, the Company owed U.S.\$2,491,667 to LaSalle Bank N.A. Our results will continue to be affected by the fluctuations of the Canadian-U.S. exchange rate. Most of our revenues and expenses in 2006 will be denominated in U.S. dollars.

Interest Expense

Interest on the term loan with LaSalle Bank N.A. for the Quarter and for the Six-Month Period were \$63,581 and \$126,483, respectively, compared to \$20,422 and \$83,301 for the corresponding periods of 2005, respectively. The increases are due to the fact that the outstanding amount of debt was at a lower level during these periods in 2005. The loan is secured against six of the Company's locomotives and U.S.\$750,000 held in a short term investment account. The loan bears interest at LIBOR plus 3.75%.

BALANCE SHEET

Our total consolidated assets were at \$95,525,018 as at June 30, 2006 compared to \$110,022,166 as at December 31, 2005. The decrease is mainly attributable to a reduction in cash and cash equivalents and accounts receivable and an increase in inventory and in our lease and demonstration fleet. During the Six-Month Period, the Company used \$38,697,590 in cash for operating activities which is reflected in the cash asset reduction.

The increase in the inventory is in line with the build-up of raw material and work-in-process related to the production ramp-up and delays in the deliveries. The lease and demonstration fleet increased by one unit, which we intend to sell later in the year.

The total consolidated liabilities were at \$51,851,451 as at June 30, 2006 compared to \$44,098,516 as at December 31, 2005. The variance is explained by the reduction in the warranty provision and by the increase in accounts payable and accrued liabilities due to the build-up of inventory and the increase in the provision for future contract losses.

CASH FLOWS

Cash and cash equivalents totaled \$37,355,337 as at June 30, 2006, a decrease of \$23,589,832 from March 31, 2006 and a decrease of \$39,474,137 from December 31, 2005.

Operating Activities

Cash used in operating activities for the Quarter and for the Six-Month Period were \$23,347,935 and \$38,697,590, respectively, compared to \$9,706,536 and \$15,348,432 for the corresponding periods of 2005, respectively.

These amounts arose from the loss for the Quarter of \$12,052,591 and for the Six-Month Period of \$22,512,034 (excluding non-cash items) and working capital increases of \$11,295,344 for the Quarter and \$16,185,556 for the Six-Month Period. Working capital requirements for the Quarter resulting in cash outflows was driven mainly by the addition of \$17,046,931 to inventory compensated partially by an increase in accounts payable and accrued liabilities of \$7,544,069. Working capital requirements for the Six-Month Period resulting in cash outflows was driven mainly by a decrease in accounts receivable in the amount of \$3,607,354, the addition of \$27,284,863 to inventory compensated partially by an increase in accounts payable and accrued liabilities of \$8,092,021.

Investing Activities

Cash used in investing activities for the Quarter and for the Six-Month Period were \$759,989 and \$1,468,597, respectively, compared to \$663 and \$3,923,042 for the corresponding periods of 2005, respectively.

The variation between the six months ended June 30, 2006 and 2005 is mainly due to a reduction in the additions to the lease and demonstration fleet in the amount of \$3,801,200.

Financing Activities

Cash provided by financing activities for the Quarter and for the Six-Month Period were \$518,092 and \$692,050, respectively, compared to \$2,103,238 and \$4,872,817 for the corresponding periods of 2005, respectively.

For the three months ended June 30, 2006 compared to the three months ended June 2005, the decrease is mainly due to a reduction in government grants in the amount of \$1,433,437. For the six months ended June 30, 2006 compared to the six months ended June 30, 2005, the decrease is largely attributable to the issuance of long term debt of \$2,358,720 in the first quarter of 2005 and to a decrease in government grants in the amount of \$1,221,437.

LIQUIDITY

Due to engineering and supplier issues, we have had to delay our production and delivery schedule. This resulted in additional pressures on our liquidity due to the mismatch between inventory levels and actual production and deliveries. In the meantime, working capital requirements to support the revised production schedule, delays in deliveries, and operational expenses will continue to be substantial during the next quarters and will weigh progressively on our actual liquidity. Consequently, the Company will require additional financing in the fourth quarter of 2006.

The Company is actively pursuing various options with potential lenders which, if accepted, will, in management's view, enable the Company to achieve its business plans. No agreements with potential lenders have been reached yet and there can be no assurance that such agreements will be reached. We expect to finalize asset-based debt financing arrangements in the fourth quarter.

Subsequent to December 31, 2005, the Company began the implementation of a very comprehensive restructuring plan to improve its operational performance. The plan started with the hiring of an experienced operations and finance team. Then, the Company designed and is implementing all the processes required to successfully manage customer's orders from bid stage to all the intermediate steps to product service. The Company also finalised and implemented its manufacturing plan. The Company is now heavily involved in restructuring its engineering organisation, renegotiating its purchase agreements, implementing a set of strong manufacturing support functions like methods, quality controls, testing and cost accounting. It is also ramping up work in process and production. At the same time, the Company is working to develop all the required manufacturing management tools like coverage charts for material, detailed estimates at completion, cash flow analysis, etc.

A task force has already been put in place by management to ensure an adequate follow-up on the inventory, including the raw material, work in process and finished goods. This task force has the mandate to plan, evaluate and control on a timely basis the required level of inventory and ensure that this level is constantly in line with the production and delivery needs.

CONTRACTUAL OBLIGATIONS AND COMMITMENTS

The following table outlines our known contractual obligations and commitments to make future payments for contracts such as commercial commitments and operating leases:

Contractual Commitments					
As at June 30, 2006	Total	Payments due by period			
		2006	2007-2008	2009-2010	2011 & beyond
Supplier purchase obligations	\$ 52,664,713	\$ 38,841,729	\$ 13,822,984	\$ -	\$ -
Operating lease obligations	2,123,057	158,029	615,028	360,000	990,000
Long term debt	2,781,198	181,383	2,599,815	-	-
Total contractual obligations	\$ 57,568,968	\$ 39,181,141	\$ 17,037,827	\$ 360,000	\$ 990,000

At June 30, 2006, we had letters of credit outstanding in favour of certain suppliers that totaled U.S. \$2,220,000 compared to U.S.\$2,500,000 at December 31, 2005. These letters of credit were secured by deposits totaling \$3,069,553 at June 30, 2006. In addition, U.S.\$750,000 is held by LaSalle as additional security for the term loans described above and U.S.\$500,000 is held by LaSalle as security for corporate credit cards.

We have not entered into any other off balance sheet arrangements, hedges or other financial instruments.

RELATED PARTY TRANSACTIONS

The Company reimburses officers and directors on a regular basis for ordinary out-of-pocket expenses incurred in the normal course of business such as travel and lodging. There were no other related party transactions during the six months ended June 30, 2006.

SELECTED QUARTERLY INFORMATION

	Three months ended		Six months ended	
	June 30, 2006 (Unaudited)	June 30, 2005 (Unaudited)	June 30, 2006 (Unaudited)	June 30, 2005 (Unaudited)
Operations data				
Sales	\$ 2,712,837	\$ 4,010,733	\$ 4,972,227	\$ 4,010,733
Cost of goods sold	4,991,255	6,105,612	9,470,091	6,782,099
Provision for future contract losses	5,698,474	-	6,569,626	-
Amortization	591,041	121,319	728,832	231,355
Warranty expense (recovery)	77,963	120,322	(933,243)	120,322
Direct selling expenses	391,509	359,412	858,265	669,710
Service expenses	1,357,990	851,701	3,005,924	1,282,500
Engineering and R&D	2,949,694	2,052,400	5,598,725	4,555,783
General and administrative	2,670,569	1,850,949	4,997,428	3,337,602
Operating loss	(16,015,658)	(7,450,982)	(25,323,421)	(12,968,638)
Interest income	521,833	288,520	1,178,026	609,112
Foreign exchange gain	309,769	329,922	351,288	265,413
Interest expense	(63,581)	(20,422)	(126,483)	(83,301)
Net loss	<u>(15,247,637)</u>	<u>(6,852,962)</u>	<u>(23,920,590)</u>	<u>(12,177,414)</u>
Net loss per share - basic	\$ (0.278)	\$ (0.161)	\$ (0.437)	\$ (0.286)
	June 30, 2006 (Unaudited)	December 31, 2005 (Audited)		
Financial position				
Net working capital	\$ 59,649,530	\$ 76,697,129		
Total assets	95,525,018	110,022,166		
Total long term debt	2,781,198	3,086,796		
Shareholders' equity	43,673,567	65,923,650		

Note: Fully diluted loss per share has not been presented, as the effect on basic loss per share would be anti-dilutive.

SUMMARY OF QUARTERLY RESULTS

	Sales ^(a)	Net Loss	Net Loss per Share ^{(b) (c)}
March 31, 2004	\$ -	\$ 2,243,247	\$0.09
June 30, 2004	\$ -	\$ 2,790,684	\$0.12
September 30, 2004	\$ -	\$ 4,436,467	\$0.14
December 31, 2004	\$ 740,000	\$ 5,481,808	\$0.16
March 31, 2005	\$ -	\$ 5,324,452	\$0.12
June 30, 2005	\$ 4,010,733	\$ 6,852,962	\$0.16
September 30, 2005	\$ 6,190,045	\$ 7,242,269	\$0.17
December 31, 2005	\$ 9,976,483	\$ 40,491,797	\$0.91
March 31, 2006	\$ 2,259,390	\$ 8,672,953	\$0.16
June 30, 2006	\$ 2,712,837	\$ 15,247,637	\$0.28

- Notes: (a) Sales have been restated to be comparative with the actual period.
(b) Diluted loss per share has not been presented for these quarters as the effect on basic loss per share would be anti-dilutive.
(c) Until recently, our initial products, the *Green Goat*[®] series of locomotives, were in the prototype stage undergoing continued development and testing. As a result, we have no history of positive earnings.

OUTSTANDING SHARE DATA

At June 30, 2006, we had 54,926,292 voting common shares issued and outstanding, compared with 54,709,625 at December 31, 2005. Also at June 30, 2006, 4,260,769 common shares are reserved for issuance under outstanding stock options. At December 31, 2005, there were 3,659,102 common shares reserved for issuance under outstanding stock options.

SIGNIFICANT ACCOUNTING POLICIES

The preparation of the financial statements in conformity with the Canadian generally accepted accounting principles requires us to make estimates and assumptions that affect the reported amounts of revenues and expenses during the period, the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities at the date of the financial statements. On an ongoing basis, we review our estimates, based upon currently available information. Actual results could differ from these estimates. The most significant accounting policies are revenue recognition and warranty provision and are detailed with the other accounting policies in note 2 to the consolidated annual financial statements as at December 31, 2005.

Our management has discussed the development and selection of our significant accounting policies with the Audit Committee of our Board of Directors and the Audit Committee has reviewed and approved the policies and the related disclosures.

RISKS AND UNCERTAINTIES

Risks and uncertainties related to product development, competitive and regulatory environments and economic and industry factors affecting the company and its results of operations, financial position and prospects are described under the heading "Risk Factors" in our Annual Information Form dated March 29, 2006, and our Managements Discussion and Analysis for the financial year ended December 31, 2005, copies of which are available on our internet website at www.railpower.com, from the internet website maintained by the Canadian Securities Administrators at www.sedar.com or by written request to our Corporate Secretary. Additional disclosure on the applicability of the going concern assumption to our financial statements and our near-term financing requirements are specifically addressed in Note 2 to our unaudited interim consolidated financial statements for the three months and six months ended June 30, 2006 and in the "Liquidity" section of this report.

INTERNAL DISCLOSURE CONTROLS

In accordance with Canadian Securities Administrators' Multilateral Instrument 52-109 – Certification of Disclosure in Issuer's Annual and Interim Filings, our President and Chief Executive Officer and Chief Financial Officer have designed, or have caused to be designed under their supervision, disclosure controls and procedures. The President and Chief Executive Officer and Chief Financial Officer are assisted in such functions by a Disclosure Committee (the "Committee") responsible for the disclosure policies established by the Board to ensure that the communication of material information to the public is timely, factual and accurate and broadly disseminated in accordance with all applicable legal and regulatory requirements. The committee is currently composed of the President and Chief Executive Officer, the Chief Financial Officer, the Executive Vice-President, the Manager Marketing and Communications and the Corporate Compliance Officer.

FORWARD-LOOKING STATEMENTS

Certain statements contained in this Management's Discussion and Analysis ("MD&A"), including the documents incorporated by reference, may contain projections and "forward-looking statements" within the meaning of that phrase under Canadian and U.S. securities laws. When used in this document, the words "may", "would", "could", "will", "intend", "plan", "anticipate", "believe", "estimate", "expect" and similar expressions may be used to identify forward-looking statements. Those statements reflect our current views with respect to future events or conditions, including prospective results of operations, financial position, predictions of future actions or plans or strategies. Certain material factors and assumptions were applied in drawing our conclusions and making those forward looking statements. By their nature, those statements reflect management's current views, beliefs and assumptions and are subject to certain risks, uncertainties, known and unknown, and assumptions, including, without limitation, product development or manufacturing delays, changing environmental regulations, the ability to attract and retain business partners, the acceptance of our existing and new products, future levels of government funding, the need to obtain and maintain proprietary rights over our technology, competition from other technologies, the ability to access the capital required for research, product development, operations and marketing, the need to generate positive cash flow in the foreseeable future, changes in energy prices and currency levels. Many factors could cause our actual results, performance or achievements to be materially different from any future results, performance or achievements that may be expressed or implied by these forward-looking statements. Should one or more of these risks or uncertainties materialize, or should the assumptions underlying our projections or forward-looking statements prove incorrect, our actual results may vary materially from those described in this report as intended, planned, anticipated, believed, estimated, or expected. We do not intend and do not assume any obligation to update these forward-looking statements whether as a result of new information, plans, events or otherwise.

RAILPOWER TECHNOLOGIES CORP.

Consolidated Balance Sheets
(Expressed in Canadian dollars)

	June 30, 2006 (Unaudited)	December 31, 2005 (Audited)
Assets		
Current assets:		
Cash and cash equivalents	\$ 37,355,337	\$ 76,829,474
Restricted cash	4,464,803	4,713,189
Accounts receivable	2,675,079	6,282,433
Deposits to supplier	920,865	-
Inventory (note 4)	41,134,785	13,849,922
Prepaid expenses	274,520	595,317
	<u>86,825,389</u>	<u>102,270,335</u>
Plant and equipment	1,611,848	1,229,914
Lease and demonstration fleet	6,008,199	5,350,173
Patents	360,960	365,760
Deferred development costs	718,622	805,984
	<u>\$ 95,525,018</u>	<u>\$ 110,022,166</u>
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 19,271,161	\$ 11,179,140
Current portion of long-term debt	2,781,198	3,086,796
Current portion of warranty provision (note 5)	474,809	318,563
Current portion of contract losses provision (note 5)	4,648,691	10,988,707
	<u>27,175,859</u>	<u>25,573,206</u>
Warranty provision (note 5)	3,545,956	4,783,955
Provision for contract losses (note 5)	18,904,237	12,029,664
Government grants	2,225,399	1,711,691
Shareholders' equity:		
Share capital (note 6)	145,940,600	145,454,777
Contributed surplus (note 6)	3,047,456	1,862,772
Deficit	(105,314,489)	(81,393,899)
	<u>43,673,567</u>	<u>65,923,650</u>
Going concern: Note 2		
Commitments: Note 7		
	<u>\$ 95,525,018</u>	<u>\$ 110,022,166</u>

The accompanying notes are an integral part of the consolidated financial statements.

Approved by the Board:

"Mark Wayne", Director

"Philip Garcia", Director

RAILPOWER TECHNOLOGIES CORP.

Consolidated Statements of Operations and Deficit
(Expressed in Canadian dollars)
(Unaudited)

	3 Months Ended June 30		6 Months Ended June 30	
	2006	2005	2006	2005
Sales	\$ 2,712,837	\$ 4,010,733	\$ 4,972,227	\$ 4,010,733
Cost of goods sold	(4,991,255)	(6,105,612)	(9,470,091)	(6,782,099)
Provision for future contract losses (note 5)	(5,698,474)	-	(6,569,626)	-
Amortization of plant and equipment and lease and demonstration fleet	(173,367)	(141,474)	(328,934)	(248,886)
Amortization and write-down of patents and deferred development costs	(437,851)	(3,300)	(440,251)	(5,924)
Amortization of government grants	20,177	23,455	40,353	23,455
Warranty recovery (expense) (note 5)	(77,963)	(120,322)	933,243	(120,322)
	(8,645,896)	(2,336,520)	(10,863,079)	(3,123,043)
Selling expenses	(391,509)	(359,412)	(858,265)	(669,710)
Service expenses	(1,357,990)	(851,701)	(3,005,924)	(1,282,500)
Engineering and research and development	(2,949,694)	(2,052,400)	(5,598,725)	(4,555,783)
General and administrative	(2,670,569)	(1,850,949)	(4,997,428)	(3,337,602)
Operating loss	(16,015,658)	(7,450,982)	(25,323,421)	(12,968,638)
Interest income	521,833	288,520	1,178,026	609,112
Foreign exchange gain	309,769	329,922	351,288	265,413
Interest expense	(63,581)	(20,422)	(126,483)	(83,301)
Loss for the period	(15,247,637)	(6,852,962)	(23,920,590)	(12,177,414)
Deficit, beginning of period	(90,066,852)	(26,806,871)	(81,393,899)	(21,482,419)
Deficit, end of period	\$ (105,314,489)	\$ (33,659,833)	\$ (105,314,489)	\$ (33,659,833)
Net loss per weighted average common share; basic and diluted	\$ (0.28)	\$ (0.16)	\$ (0.44)	\$ (0.29)
Weighted average number of common shares outstanding; basic and diluted	54,840,578	42,670,504	54,775,555	42,557,270

The accompanying notes are an integral part of the consolidated financial statements.

RAILPOWER TECHNOLOGIES CORP.

Consolidated Statements of Cash Flows
(Expressed in Canadian dollars)
(Unaudited)

	3 Months Ended June 30		6 Months Ended June 30	
	2006	2005	2006	2005
Cash flows from operating activities:				
Loss for the period	\$ (15,247,637)	\$ (6,852,962)	\$ (23,920,590)	\$ (12,177,414)
Items not involving cash:				
Amortization of plant and equipment and lease and demonstration fleet	173,367	141,474	328,934	248,886
Amortization and write-down of patents and deferred development costs	437,851	3,300	440,251	5,924
Amortization of government grants	(20,177)	(23,455)	(40,353)	(23,455)
Stock-based compensation	585,007	336,998	1,226,920	542,933
Changes in non-cash operating assets and liabilities:				
Decrease (increase) in accounts receivable	(1,030,695)	(2,359,225)	3,607,354	(2,456,957)
Increase in deposits to supplier	(920,865)	-	(920,865)	-
Increase in inventory	(17,046,931)	(2,364,214)	(27,284,863)	(1,620,206)
Decrease (increase) in prepaid expenses	159,078	(401,046)	320,797	(1,350,729)
Increase in accounts payable and accrued liabilities	7,544,069	2,036,188	8,092,021	1,704,185
Decrease in customer deposits	-	(223,594)	-	(221,599)
Decrease in warranty provision	(74,491)	-	(1,081,753)	-
Increase in provision for contract losses	2,093,489	-	534,557	-
Net cash used in operating activities	(23,347,935)	(9,706,536)	(38,697,590)	(15,348,432)
Cash flows from investing activities:				
Decrease (increase) in restricted cash	(135,614)	109,539	248,386	108,581
Expenditures on patents	-	(59,892)	-	(124,265)
Expenditures on plant and equipment	(317,694)	(168,322)	(641,317)	(214,626)
Lease and demonstration locomotive sold	-	616,727	-	616,727
Investment in lease and demonstration fleet	(40,673)	(21,865)	(727,577)	(3,823,065)
Increase in deferred development costs	(266,008)	(476,850)	(348,089)	(486,394)
Net cash used in investing activities	(759,989)	(663)	(1,468,597)	(3,923,042)
Cash flows from financing activities:				
Issuance of long-term debt	-	-	-	2,358,720
Repayment of long-term debt	(223,969)	(53,777)	(305,598)	(79,127)
Issuance of common stock for cash, net of share issue costs	400,000	381,517	443,587	817,726
Increase in government grants	342,061	1,775,498	554,061	1,775,498
Net cash provided by financing activities	518,092	2,103,238	692,050	4,872,817
Net decrease in cash and cash equivalents	(23,589,832)	(7,603,961)	(39,474,137)	(14,398,657)
Cash and cash equivalents, beginning of period	60,945,169	47,118,288	76,829,474	53,912,984
Cash and cash equivalents, end of period	\$ 37,355,337	\$ 39,514,327	\$ 37,355,337	\$ 39,514,327

The accompanying notes are an integral part of the consolidated financial statements.

RAILPOWER TECHNOLOGIES CORP.

Notes to Consolidated Financial Statements
(Expressed in Canadian dollars)
(Unaudited)

1. The Company

Railpower Technologies Corp. (the "Company" or "Railpower") is a public company listed on the Toronto Stock Exchange ("TSX") formed under the Canada Business Corporations Act on June 30, 2001.

The Company is a developer of new technologies with applications in rail transportation and other derivative markets and industries.

A subsidiary, Railpower Hybrid Technologies Corp., was incorporated under the laws of the State of Washington in January 2004 and has its principal office in Erie, Pennsylvania.

2. Going concern

These consolidated financial statements have been prepared on a going concern basis in accordance with Canadian generally accepted accounting principles. The going concern basis of presentation assumes that the company will continue in operation for the foreseeable future and be able to realize its assets and discharge its liabilities and commitments in the normal course of business. There is doubt about the appropriateness of the use of the going concern assumption because the Company experienced significant losses in 2006 and 2005 and has experienced significant negative cash flow from operations over a number of years. Due to engineering and supplier issues, we have had to delay our production and delivery schedule. This resulted in additional pressures on our liquidity due to the mismatch between inventory levels and actual production and deliveries. In the meantime, working capital requirements to support the revised production schedule, delays in deliveries, and operational expenses will continue to be substantial during the next quarters and will weigh progressively on our actual liquidity. Consequently, the Company will require additional financing in the fourth quarter of 2006. Discussions are ongoing with potential lenders regarding asset-based debt financing arrangements.

Subsequent to December 31, 2005, the Company began the implementation of a very comprehensive restructuring plan to improve its operational performance. The plan started with the hiring of an experienced operations and finance team. Then, the Company designed and is implementing all the processes required to successfully manage customer orders from the bid stage to all the intermediate steps through to product service. The Company also finalised and implemented its manufacturing plan. The Company is now heavily involved in restructuring its engineering organisation, renegotiating its purchase agreements, and implementing a set of strong manufacturing support functions such as methods, quality controls, testing and cost accounting. It is also ramping up work in process and production. At the same time, the Company is working to develop all the required manufacturing management tools such as coverage charts for material, detailed estimates at completion, cash flow analysis, etc.

A task force has already been put in place by management to ensure an adequate follow-up on the inventory, including the raw material, work in process and finished goods. This task force has the mandate to plan, evaluate and control on a timely basis the required level of inventory and ensure that this level is constantly in line with the production and delivery needs.

RAILPOWER TECHNOLOGIES CORP.

Notes to Consolidated Financial Statements
(Expressed in Canadian dollars)
(Unaudited)

2. Going concern (continued)

The Company is actively pursuing various options with potential lenders which, if accepted, will, in management's view, enable the Company to achieve its business plans. No agreements with potential lenders have been reached yet and there can be no assurance that such agreements will be reached.

The ability of the Company to continue as a going concern and to realize the carrying value of its assets and discharge its liabilities when due is dependent on the successful completion of the actions taken or planned, some of which are described above, which management believes will mitigate the adverse conditions and events which raise doubt about the validity of the "going concern" assumption used in preparing these financial statements. There is no certainty that these and other strategies will be sufficient to permit the Company to continue operating during the next twelve months.

The financial statements do not reflect any adjustments that would be necessary if the "going concern" assumption were not appropriate. If the "going concern" basis was not appropriate for these financial statements, then adjustments would be necessary in the carrying value of assets and liabilities, the reported revenues and expenses, and the balance sheet classifications used.

3. Basis of presentation

In the opinion of management, these unaudited interim consolidated financial statements, prepared in accordance with Canadian generally accepted accounting principles ("GAAP"), contain all adjustments necessary to fairly present Railpower's financial position as at June 30, 2006 as well as its results of operations and its cash flows for the three months and six months ended June 30, 2006 and 2005.

These unaudited interim consolidated financial statements do not include all of the information and disclosures required by GAAP for annual financial statements. While management believes that the disclosures presented are adequate, these unaudited interim consolidated financial statements and notes should be read in conjunction with Railpower's annual consolidated financial statements for the year ended December 31, 2005.

These unaudited interim consolidated financial statements follow the same accounting policies as the most recent annual consolidated financial statements.

RAILPOWER TECHNOLOGIES CORP.

Notes to Consolidated Financial Statements
(Expressed in Canadian dollars)
(Unaudited)

4. Inventory

	June 30, 2006	December 31, 2005
Raw materials	\$ 18,714,743	\$ 9,541,863
Work in process	15,933,646	1,763,500
Finished goods in transit	4,060,416	2,013,154
Subject to conditional sales contracts	2,425,980	531,405
	<u>\$ 41,134,785</u>	<u>\$ 13,849,922</u>

5. Provisions for warranties, future contract losses and development costs

	June 30, 2006	December 31, 2005
<u>Current portion</u>		
Warranty provision	\$ 474,809	\$ 318,563
Provision for future contract losses	4,648,691	10,988,707
Provision for development costs	-	300,000
<u>Long-term portion</u>		
Warranty provision	3,545,956	4,783,955
Provision for future contract losses	18,904,237	12,029,664
	<u>\$ 27,573,693</u>	<u>\$ 28,420,889</u>

As at December 31, 2005, the Company had a provision of \$28,420,889 for warranties, future contract losses and development costs related to the Company's GG-series hybrid yard switcher locomotive models.

(a) Current portion of warranty provision

The current portion of warranty provision represents the expected costs of the general warranty for the next twelve months on each locomotive that has been sold at June 30, 2006. This provision is based on historical data and expectations from management and depends on the number of locomotives sold that are still under warranty.

(b) Warranty provision

The Company recorded in December 2005 an amount of \$4,783,955 in additional warranty costs for future battery pack replacements and generator set ("genset") upgrades on sold GG20B series locomotives.

RAILPOWER TECHNOLOGIES CORP.

Notes to Consolidated Financial Statements
(Expressed in Canadian dollars)
(Unaudited)

5. Provisions for warranties, future contract losses and development costs (continued)

(b) Warranty provision (continued)

During the quarter ended March 31, 2006, we have launched an equipment inspection program. The information obtained from this program as well as additional operating data gathered from our units in service and further analysis of that data have allowed us to better understand all factors affecting battery life. We have also modified the final design for the Generation III GG20B locomotive to further improve battery life. As a result, we estimated that we would incur lower warranty costs and, therefore, we had decreased the provision by \$1,105,545 as at March 31, 2006.

As at June 30, 2006, the provision was reviewed by management and technical specialists and, as a result, it was concluded that no changes were required to the provision when compared to the March 31, 2006 provision. The variation of the provision in the three months ended June 30, 2006 is only due to the exchange rate fluctuation during these periods.

RAILPOWER TECHNOLOGIES CORP.

Notes to Consolidated Financial Statements
(Expressed in Canadian dollars)
(Unaudited)

5. Provisions for warranties, future contract losses and development costs (continued)

(c) Provision for future contract losses

As at December 31, 2005, the estimate for future contract losses amounted to \$23,018,371. This provision was decreased by \$1,558,932 as at March 31, 2006 and increased by \$2,093,489 as at June 30, 2006 as explained below:

<u>Balance as at December 31, 2005</u>		
Current portion	\$	10,988,707
Long term portion		<u>12,029,664</u>
	\$	<u>23,018,371</u>
Actual costs incurred during the first quarter of 2006		(2,430,084)
Effect on the first quarter of 2006 operations		
Increase in provision	\$	4,591,931
Reversal - Battery replacement		(3,839,169)
Loss on new contract		<u>118,390</u>
		<u>871,152</u>
<u>Balance as at March 31, 2006</u>		
Current portion		11,729,390
Long term portion		<u>9,730,049</u>
	\$	<u>21,459,439</u>
Actual costs incurred during the second quarter of 2006		(3,549,867)
Effect on the second quarter of 2006 operations		
Increase in provision	\$	5,698,474
Foreign exchange rate impact		<u>(55,118)</u>
		<u>5,643,356</u>
<u>Balance as at June 30, 2006</u>		
Current portion	\$	4,648,691
Long term portion		<u>18,904,237</u>
	\$	<u>23,552,928</u>

RAILPOWER TECHNOLOGIES CORP.

Notes to Consolidated Financial Statements
(Expressed in Canadian dollars)
(Unaudited)

5. Provisions for warranties, future contract losses and development costs (continued)

(c) Provision for future contract losses (continued)

During the three months ended March 31, 2006, we completed a review of the contracts using new data obtained from our manufacturing sites and from units in service as discussed above. Based on this review and actual data collected during the first quarter of 2006, we increased our estimate of the provision for future contract losses to account for additional labour and material costs and reduced the provision for battery replacement based on the estimated extended battery life previously disclosed.

This review was also conducted as at June 30, 2006 using the most recent data available from completed Generation III GG20B locomotives at the end of the quarter. As a result, we increased our estimate for future contract losses by \$5,643,356 to reflect increases in labor, material costs and manufacturing overhead expenses anticipated to be incurred in completing the contracts due to engineering delays and continuous production and quality issues.

Management is actively working on a plan to mitigate losses related to this provision.

(d) Provision for development costs

A provision amounting to \$300,000 was recorded in accounts payable and accrued liabilities at December 31, 2005 for the development costs of the third generation of the GG20B model. During the three months ended June 30, 2006, the project was completed and the expenses incurred were applied against the provision.

6. Share capital

(a) Authorized:

Unlimited number of voting common shares without nominal or par value

Unlimited number of non-voting preferred shares without nominal or par value

(b) Common shares issued:

	Shares	Amount	Contributed surplus
Balance, December 31, 2005	54,709,625	\$ 145,454,777	\$ 1,862,772
Stock-based compensation	-	-	641,913
Issued on exercise of options	16,667	60,742	(12,901)
Share issuance costs	-	(4,254)	-
Balance, March 31, 2006	54,726,292	145,511,265	2,491,784
Stock-based compensation	-	-	585,007
Issued on exercise of options	200,000	429,335	(29,335)
Balance, June 30, 2006	54,926,292	\$ 145,940,600	\$ 3,047,456

RAILPOWER TECHNOLOGIES CORP.

Notes to Consolidated Financial Statements
(Expressed in Canadian dollars)
(Unaudited)

6. Share capital (continued)

(c) Stock option plan:

The Company's stock-based compensation plan for its directors, officers, consultants and employees allows a number of options equal to 12% of the outstanding common shares. The outstanding options issued under the plan vest over a period of up to five years. The status of the Company's stock-based compensation plan as at June 30, 2006 and changes during the three months and six months ended on this date are presented below:

	Number of shares	Weighted average price
Outstanding, December 31, 2005	3,659,102	\$4.04
Granted	666,000	\$3.83
Exercised	(16,667)	\$2.36
Expired/Cancelled	(56,666)	\$5.08
Outstanding, March 31, 2006	4,251,769	\$4.14
Granted	341,000	\$4.20
Exercised	(200,000)	\$2.00
Expired/Cancelled	(132,000)	\$4.68
Outstanding, June 30, 2006	4,260,769	\$3.92
Exercisable, June 30, 2006	1,494,750	\$3.27

At June 30, 2006, the Company had reserved a total of 4,260,769 common shares related to issued director and employee options:

Exercise prices	Number outstanding June 30, 2006	Exercisable at June 30, 2006	Weighted - average remaining contractual life (years)
\$1.00 - \$1.99	459,000	453,666	0.7
\$2.00 - \$2.99	441,768	321,595	2.4
\$3.00 - \$3.99	1,031,500	196,330	4.1
\$4.00 - \$4.99	431,000	41,666	4.6
\$5.00 - \$5.99	1,387,500	434,828	4.0
\$6.00 - \$6.68	510,001	46,665	4.5
	4,260,769	1,494,750	3.6

RAILPOWER TECHNOLOGIES CORP.

Notes to Consolidated Financial Statements
(Expressed in Canadian dollars)
(Unaudited)

6. Share capital (continued)

(c) Stock option plan (continued):

The fair value of the options granted has been determined using the Black-Scholes option pricing formula using the following assumptions:

	3 months ended June 30		6 months ended June 30	
	2006	2005	2006	2005
Risk-free interest rate	4.00%	2.50%	3.00%	2.50%
Expected life	4	4	4	4
Expected volatility	76%	41%	70%	43%
Expected dividends	-	-	-	-

The stock-based compensation expense for the three months and six months ended June 30, 2006 were \$585,007 and \$1,226,920 (\$336,998 and \$542,933 in 2005), respectively.

7. Contractual obligations and commitments

The following table outlines our known contractual obligations and commitments to make future payments for contracts such as commercial commitments and operating leases:

Contractual Commitments					
As at June 30, 2006	Total	Payments due by period			
		2006	2007-2008	2009-2010	2011 & beyond
Supplier purchase obligations	\$ 52,664,713	\$ 38,841,729	\$ 13,822,984	\$ -	\$ -
Operating lease obligations	2,123,057	158,029	615,028	360,000	990,000
Long term debt	2,781,198	181,383	2,599,815	-	-
Total contractual obligations	\$ 57,568,968	\$ 39,181,141	\$ 17,037,827	\$ 360,000	\$ 990,000

At June 30, 2006, we had letters of credit outstanding in favour of certain suppliers that totaled U.S. \$2,220,000 compared to U.S.\$2,500,000 at December 31, 2005. These letters of credit were secured by deposits totaling \$3,069,553 at June 30, 2006. In addition, U.S.\$750,000 is held by LaSalle as additional security for the term loans described above and U.S.\$500,000 is held by LaSalle as security for corporate credit cards.

We have not entered into any other off balance sheet arrangements, hedges or other financial instruments.

RAILPOWER TECHNOLOGIES CORP.

Notes to Consolidated Financial Statements
(Expressed in Canadian dollars)
(Unaudited)

8. Comparative figures

Certain comparative figures have been reclassified to conform with the presentation adopted in the current period.