

MANAGEMENT DISCUSSION & ANALYSIS

SECOND QUARTER 2006

This discussion and analysis is a review of the operating results, financial condition, and business risks of PhotoChannel Networks Inc. (“PhotoChannel” or the “Company”). This discussion should be read in conjunction with the Management’s Discussion and Analysis presented in PhotoChannel’s 2005 Annual Report and the consolidated financial statements and accompanying notes for the six months ended March 31, 2006 and 2005. The financial information reported herein has been prepared in accordance with Canadian Generally Accepted Accounting Principles (“GAAP”) and is presented in Canadian dollars, unless otherwise noted.

This discussion and analysis may contain forward-looking statements. Statements which are not historical facts reflect the Company’s views at May 29, 2006 with respect to future events and are subject to certain risks, uncertainties and assumptions. These risks and assumptions include, but are not limited to, changes in the market for our services, changes in the economy, increasing competition in our market, the risk of loss of current customers, risks related to changes in technology, employee retention, inability to deliver on contracts, failure of customers to adequately market the online photo-finishing services they provide, foreign exchange, our limited operating history, and risks with respect to our financial capacity. These risks are set out in greater detail in our Form 20F filed for the year ended September 30, 2005, available on the SEC’s website at <http://www.sec.gov/edgar.shtml>. The Company’s actual results could differ materially for those expressed or implied by such forward-looking statements

We are pleased to provide you with an update on the progress PhotoChannel made in its second quarter of fiscal 2006 ended March 31, 2006.

Business Highlights

For Q2 – FY06 PhotoChannel reports that:

- Revenues for the six months ended March 31, 2006 were \$1,373,859, up 38% or \$378,503 over the corresponding period of 2005. Revenue continues to be driven by increases in installation, membership and transaction fees, which increased by 34%, 34%, and 39%, respectively, from the first two quarters of fiscal 2005.
- Although the period from October to December is historically the best quarter in photofinishing, the Company’s transactional during the second quarter revenue was up 33% from the first quarter of fiscal 2006, from \$233,733 to \$309,940.
- An agreement with CVS/pharmacy whereby CVS/pharmacy will deploy PNI Digital Media Platform to offer online photo printing for its customers and pick up in any of over 5,000 CVS/pharmacy locations across the United States. CVS is now completing its rollout of the in-store print solution to offer its customers a one hour online digital photofinishing solution. When this rollout is completed it will be the largest distributed printing network offered by any retailer in North America. Completion is scheduled for June 2006. www.cvs.com
- In March 2006, Costco Canada completed rollout of all of its locations offering an online to in-store print solution for its customers. www.costco.ca
- It signed an agreement to provide PNI Digital Media Platform to Wal-Mart Puerto Rico’s 27 locations. Deployment and rollout was completed in May 2006.

- It signed an agreement with Hy-Vee, Inc (“Hy-Vee”) whereby Hy-Vee will deploy PNI Digital Media Platform to offer online photo printing through the Hy-Vee website located at www.hy-vee.com.
- It launched a prepaid card driven online photo service (www.photosdirect2u.ca) for Visions Electronics (“Visions”). The online service will be utilized to expand Vision’s product offering and to provide a base for ongoing marketing, customer loyalty and e-commerce programs.
- It signed an agreement with Katz Group Canada (“Katz”) and has deployed its PNI Digital Media Platform to deliver Rexall™ Photo Centre an online solution located at www.rexall.ca.
- It partnered with Datawave Systems Inc. to expand the Black’s Prepaid Photo-finishing program. Black’s Prepaid Photo Cards are now available at Petro Canada, Shell, Scholtens, HDS, Needs, Irving Oil, Stop’n Cash, Cash Now, Wilson Fuels, Mac’s, and Husky.
- It partnered with PassAlong Networks to launch the PNI Digital Media Platform for digital music that provides customers with the ability to purchase digital music online and the pick up a CD of their selection(s) within one hour at a nearby retail store, as is now offered for digital photos.
- It integrated its Digital Media Platform with Sony’s ImageStation and has launched this with Blacks Photo and Wal-Mart Canada to offer same-day digital prints in-store for ImageStation’s members.
- Subsequent to the period end, PhotoChannel announced a non-brokered private placement of \$2 million or 20,000,000 units. Each such unit comprising one common share of the Company and one half of one non-transferable share purchase warrant, each full warrant entitling the purchase of an additional common share of the Company for a period of one year, from the date of close, at a price of \$0.15. On May 29, 2006, the Company announced that it has closed, subject to TSX Venture Exchange approval, the previously announced non-brokered private placement in the amount of \$2,750,000 upon issuance of 27,500,000 units.

RESULTS OF OPERATIONS

	Six month ended March 31, 2006	Six month ended March 31, 2005
Revenue	\$ 1,373,859	\$ 995,356
Loss from operations	(1,425,863)	(1,229,083)
Net loss	(1,421,261)	(1,220,486)
Basic and diluted net loss per share	\$ (0.01)	\$ (0.01)

The Company has four main sources of revenue derived from the provision of the PhotoChannel Network to electronically connect photo-finishing retailers to their customers through the Internet: installation revenue, membership fees, transaction fees and archive fees. Revenue received in advance from installation services for the set-up of a customer website is recorded as deferred revenue and is recognized into income over the estimated term of the customer relationship period. Revenue from monthly membership fees from photo-finishing retailers for the connection to the PhotoChannel Network is recognized as the service connection is provided. Revenue from transactions processed by the photo-finishing retailers, utilizing the PhotoChannel Network, is recognized at the time the digital image processing services are provided to the end customer. Revenue from archive fees from online image storage is recognized as the service is provided.

Network revenue increased 38% to \$1,373,859 for the period ending March 31, 2006 compared to the same period last year. Revenue from Canadian retailers increased 77% or \$563,583 from the same period last year. The increase was attributable to three factors: organic growth in usage of the network from customers of the Company's photo-finishing retailers; the Company's retailers commencing to print in-store; and the addition of additional customers. Revenue from US retailers decreased 69% or \$182,377 from the same period last year. This decrease was primarily due to the loss of a 63 store test with Costco USA, which ended in the Company's 3rd quarter of fiscal 2005, but significantly contributed to US based revenues during the Company's first and second quarters of 2005.

Primary increases occurred in installation, membership and transaction fees, which increased 34%, 34% and 39%, respectively, for the period ending March 31, 2006. Installation fees increased to \$370,177 as a result of customers connecting stores directly to the Network to facilitate in store printing of photos and installation of CD burning devices in certain Wal-Mart locations, which will allow Wal-Mart to produce picture CD's in-store, as well as music CD's in the future. These installation fees are offset by the cost of installing the locations in the amount of \$269,380. As a result of these new connections, membership fees also increased to \$329,013. With the increased number of installations, the Company expects to see membership fees remain constant or to increase as stores of our new and existing customers continue to be connected to the Network providing in-store printing. Installation fees and expenses will also increase as stores are connected to the Network. Transaction revenue for the six month period ended March 31, 2006 was up 39% from the comparable period of fiscal 2005 from \$391,778 to \$543,673. Transactional revenue was negatively impacted over the comparable period by the end of the 63 store test with Costco USA. Transactional revenue, however, was up 33% from the first quarter of fiscal 2006, from \$233,733 to \$309,940. The Company's past experience is that transaction revenue increases as stores are connected to the Network for in-store printing. The Company expects that the installations made during the first half of fiscal 2006 will continue to benefit the Company going forward.

The Company's costs of operations for the six month period ended March 31, 2006 were \$2,799,722, up 26% when compared to the same period of 2005. This increase was primarily attributable to: an increase in research and development as the Company launched existing customers onto its new platform and commenced development of its new music platform; the cost of Network delivery as a result of the increase in the adoption of the Company's online solution and the installation of hardware; and an increase in sales and marketing due to advertising and promotion.

General and administration expenses for six months ended March 31, 2006 increased by \$44,989 to \$700,753, an increase of 7% from the comparable period last year. This increase was due to a charge for stock-based compensation.

Sales and marketing expenses for the six months ended March 31, 2006 increased by \$36,535 to \$352,056, an increase of 12% from the comparable period of 2005. This increase was due to expansion into the US market and an increase in printing, advertising and promotion. As a result of our increased marketing activities during the first half of fiscal 2006, the Company was able to attract new customers, including CVS/pharmacy and Wal-Mart Puerto Rico.

Network delivery expenses for the six months ended March 31, 2006 increased by \$248,392 to \$616,284, an increase of 68% from the comparable period of 2005. This increase was primarily due to an increase of \$139,688, or 108%, related to the installation of lab systems required for direct to in-store printing and CD burning, as well as an increase in customer service of \$64,129, to \$164,258 or 64% due to increased staffing to meet the requirements of our customers, including new customers such as Wal-Mart Puerto Rico.

Research and development expenses for the six months ended March 31, 2006 increased by \$200,831 to \$974,252, an increase of 26% from the comparable period of 2005. This increase was due to an increase of staffing to develop the next generation multi-media Digital Content distribution platform, along with

development specifically related to the deliver of music. The completion of this new platform allows the Company to provide its retailers printing in-store the ability to offer a one hour solution and the subsequent completion of the music component will allow the Company to offer existing and new customers the ability to sell music through this distribution platform.

Amortization expense for the six months ended March 31, 2006 increased by \$44,536 to \$156,377, an increase of 40% from the comparable period of 2005. This increase was due to the purchase of equipment during fiscal 2005 and 2006 for the new platform and increased staffing.

The Company recorded a six month net loss attributable to common shareholders of \$1,421,261 or \$0.01 per share compared to \$1,220,486 or \$0.01 per share in the same period last year. This increase of 16% was primarily due to increases in network delivery which resulted from increased installations as well as increased staffing, and research and development expenses related to the new platform and development of a music component, and was offset by an increase in revenues. As our new customers commence conducting transactions through the Network, the Company believes that the increase in expenses will be more than offset by the related increase in revenues going forward.

Contingencies

As of May 29, 2006, there were no legal proceedings material to the Company to which the Company or its subsidiaries are a party or to which their property is subject, nor to the best of the knowledge of management, are any such legal proceedings contemplated.

FINANCIAL CAPABILITY

As at March 31, 2006, the Company had a working capital deficiency of \$571,412 compared to a working capital deficiency of \$391,151 as at March 31, 2005. The cash and cash equivalents on hand at the period ended were \$294,281. As a start-up, which continues to strive for profitability, the Company's main source of funds to meet cash shortfalls has been, and will continue to be, the sale of equity capital until it manages to reach a cashflow positive position. If requisite funding on acceptable terms cannot be attracted in a timely fashion, the Company may be forced to delay activities and, possibly, lose market opportunities to competitors. Similarly, delayed financing could force reductions in planned marketing, product deployment and development expenditures, resulting in delays in meeting its business objectives.

The contractual obligations and payments due for each of the next three years have not materially changed from the Management's Discussion and Analysis presented in the 2005 Annual Report.

TAXATION AND OTHER NON-OPERATING ITEMS

Since inception PhotoChannel has sustained significant tax losses and continues to strive to generate sufficient revenues to cover its operating costs in an industry characterized by rapid technological change.

FUTURE ACCOUNTING CHANGES

In January 2005, the Canadian Institute of Chartered Accountants ("CICA") released new Handbook Section 3855, "Financial Instruments - Recognition and Measurement", effective for annual and interim periods beginning on or after October 1, 2006. This new section prescribes when a financial instrument is to be recognized on the balance sheet and at what amount, sometimes using fair value and other times using cost-based measure. It also specifies how financial instrument gains and losses are to be presented and defines financial instruments to include accounts receivable and payable, loans, investments in debt

and equity securities, and derivative contracts. The Company has not yet determined the impact of the adoption of this standard on its consolidated results of operations or financial position.

In September 2005, the CICA issued EIC 156, "Accounting by a Vendor for Consideration Given to a Customer (Including a Reseller of the Vendor's Products)" which will apply retroactively, with restatement of prior periods, to all interim and annual financial statements for fiscal years beginning on or after January 1, 2006. EIC 156 addresses the classification and accounting for sales and other incentives paid to customers, such as discounts, coupons, rebates, free products or services, and co-operative advertising arrangements. The Company is currently assessing the impact of adopting this section on its financial results for the year ending September 30, 2006.

CRITICAL ACCOUNTING ESTIMATES

PhotoChannel prepares its financial statements in accordance with Canadian GAAP. The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Estimates are based upon historical experience and various other assumptions that are believed to be reasonable under the circumstances. These estimates are evaluated on an ongoing basis and form the basis for making judgments regarding the carrying values of assets and liabilities and the reported amount of revenues and expenses. Actual results may differ from these estimates under different assumptions.

Revenue recognition

Revenue is earned from the provision of the PhotoChannel Network to electronically connect photo-finishing retailers to their customers through the Internet. Revenue received in advance for installation services for the set-up of a customer website is recorded as deferred revenue and is recognized into income over the estimated term of the customer relationship period. Revenue from monthly membership fees from photo-finishing retailers for the connection to the PhotoChannel Network is recognized on a monthly basis as the service connection is provided. Revenue from commissions earned on transactions processed by the photo-finishing retailers, utilizing the PhotoChannel Network, is recognized at the time the digital image processing services are transacted through the Network. Revenue from archive fees for online image storage is recognized as the service is provided.

Income taxes

The company uses the liability method of accounting for income taxes. Under the liability method, future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax balances. Future tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment. A valuation allowance is recognized to the extent the recoverability of future income tax assets is not considered more likely than not.

BUSINESS RISKS

The business risks described in the Management's Discussion and Analysis presented in the 2005 Annual Report have not materially altered.

MANAGEMENT'S STATEMENT OF RESPONSIBILITY

The consolidated financial statements contained in this report have been prepared by management in accordance with generally accepted accounting principles and have been approved by the Board of Directors. The integrity and objectivity of the consolidated financial statements are the responsibility of management. In addition, management is responsible for all other information in this report and for ensuring that this information is consistent, where appropriate, with the information contained in the consolidated financial statements.

Management maintains a system of internal accounting controls to provide reasonable assurance that the Company's assets are safeguarded and accounted for, and to facilitate the preparation of relevant, reliable, and timely financial information. Where necessary, management uses its best judgment to make estimates required to ensure fair and consistent presentation of this information.

The Company's management, including the Chief Executive Officer and Chief Financial Officer, believe that any disclosure controls and procedures or internal controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, they cannot provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been prevented or detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by unauthorized override of the control. The design of any systems of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Accordingly, because of the inherent limitations in a cost effective control system, misstatements due to error or fraud may occur and not be detected.

There has been no change in the Company's internal control over financial reporting during the Company's first two quarters of fiscal 2006, ended March 31, 2006 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control, and exercises this responsibility principally through the Audit Committee. The Audit Committee includes four directors, three of whom are not involved in the daily operations of the Company. The functions of the Audit Committee are to review the quarterly and annual consolidated financial statements; review the adequacy of the system of internal controls; review any relevant accounting, financial and security regulatory matters; and recommend the appointment of external auditors.

QUARTERLY FINANCIAL INFORMATION

The following table provides selected quarterly information for PhotoChannel's eight most recent quarters. This information is unaudited, but reflects all adjustments of a normal, recurring nature which are, in the opinion of management, necessary to present a fair statement of PhotoChannel's results of operations for the periods presented. Quarter-to-quarter comparisons of PhotoChannel's financial results are not necessarily meaningful and should not be relied upon as an indicator of future performance.

	Jun. 30, 2004	Sept. 30, 2004	Dec. 31, 2004	Mar. 31, 2005
Revenue	\$ 202,783	\$ 141,507	\$ 440,614	\$ 554,742
Net loss for the period	647,046	1,261,202	477,870	751,213
Net loss attributable to common shareholders	649,049	1,261,202	476,778	743,708
Basic and diluted net loss per share	\$ -	\$ 0.01	\$ -	\$ -

	Jun. 30, 2005	Sept. 30, 2005	Dec. 31, 2005	Mar. 31, 2006
Revenue	\$ 564,775	\$ 556,372	\$ 542,714	\$ 831,145
Net loss for the period	892,617	1,046,061	613,004	812,859
Net loss attributable to common shareholders	896,780	1,030,701	615,366	805,895
Basic and diluted net loss per share	\$ 0.01	\$ 0.01	\$ -	\$ -

OUTSTANDING SHARE INFORMATION AS AT May 29, 2006

Authorized

Common shares	Unlimited
Preferred shares	Unlimited

Issued and outstanding

Common shares	220,514,841
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Options Outstanding 14,741,771

Warrants Outstanding 30,568,750

The statements that are not historical facts contained in this release are forward-looking statements that involve risks and uncertainties. PhotoChannel's actual results could differ materially for those expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, changes in technology, employee retention, inability to deliver on contracts, failure of customers to continue marketing the online solution, competition, general economic conditions, foreign exchange and other risks detailed in the Company's annual report and other filings. Additional information related to the Company can be found on SEDAR at www.sedar.com

Notice of no auditor review of interim consolidated financial statements

Under National Instrument 51-102, Part 4, subsection 4.3 (3)/(a), if an auditor has not performed a review of the interim financial statements, they must be accompanied by a notice indicating that the financial statements have not been reviewed by an auditor.

The interim consolidated financial statements of the Company, as at and for the period ended December 31, 2005, have been prepared by and are the responsibility of the Company's management.

The Company's independent auditor has not performed a review of these financial statements in accordance with standards established by the Canadian Institute of Chartered Accountants for a review of interim financial statements by an entity's auditor.

ADDITIONAL INFORMATION

Additional information related to the Company can be found on SEDAR at www.sedar.com.