

COALITION OF | **CANADIAN ENERGY TRUSTS**

# **Canadian Energy Trusts**

**An Integral Component of the  
Canadian Oil and Gas Industry**

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## Executive Summary

This report summarizes the perspective of the Coalition of Canadian Energy Trusts (“CCET”) regarding the Government of Canada’s announcement of October 31, 2006 with respect to energy trusts. The CCET also fully supports the initiatives of the Canadian Association of Income Funds (“CAIF”) in regard to reconsideration of the tax proposals made by the Minister of Finance.

### **Do Energy Trusts Cause Federal Tax Leakage?**

No. Federal and provincial government revenues are actually enhanced by the energy trust structure. During the past five years, CCET member trusts have generated greater taxes both provincially and federally than would have occurred had they been structured as corporations.

In 2005, the oil and gas trust sector generated over 30 percent of the tax revenue collected from publicly-traded Canadian entities in the oil and gas sector while representing only 16 percent of the revenue. Oil and gas royalty trusts have also generated over 40 percent more taxes than Canadian publicly-traded senior independent producers on a unit-of-production basis.

The capital intensity of oil and gas exploration and production generates significant tax pools. As a result, oil and gas exploration and production corporations have historically paid minimal corporate taxes. In contrast, distributions from energy trusts generate:

- current personal income taxes from Canadians;
- additional tax from compounding investment in tax-deferred accounts; and
- a 15 to 25 percent withholding tax from foreign investors.

Because most CCET unitholders live outside Alberta, where all energy trusts are based, Canadians throughout the country share in the distributions paid and their provinces of residence benefit through hundreds of millions of dollars of increased tax revenues. Alberta, in turn, receives the benefit of additional royalties on mature oil and gas producing assets, spending on goods and services in the province, employment and associated taxes, and all of the ancillary economic spin-offs associated with increased activity.

### **Other Tax Considerations**

- As long as there is no reduction in total tax paid, sources should be irrelevant to the government, especially given that the government is currently experiencing surpluses from its tax revenue collections.
- The federal government surplus is supported by taxes being collected directly on distributions and from taxes being paid on retirement plan withdrawals.

- Canadians' retirement plans are "tax-deferred", not "tax exempt".
- Trust distributions in tax-deferred accounts act as huge savings accounts for the government and serve to increase government tax revenues because:
  - there is a gain to government revenues when trusts or other securities are held inside tax-deferred accounts; and
  - the tax cost of the contributions in any given year is offset by taxes collected on the withdrawals in any given year.
- The existing 15 to 25 percent withholding tax on distributions to foreign investors generates substantial revenues to the government, without any corresponding use of services or infrastructure.
- Should a significant portion of the trust's assets revert to foreign ownership, tax value will most likely leave the country in the form of deductible interest in Canada which will be subject to only 0 to 10 percent withholding tax and from taxation of capital gains in foreign jurisdictions and not taxed in Canada.

### **Do Energy Trusts Threaten Canada's Long-term Economic Growth?**

On the contrary, energy trusts are the ideal model for Canada's mature hydrocarbon basins. Since their introduction in 1986, they have played a unique role in maximizing oil and gas production and reserve recovery and providing essential capital to Canada's energy industry.

The Western Canada Sedimentary Basin ("WCSB") has matured rapidly in the past twenty years. Despite record levels of drilling activity and capital spending:

- Canadian conventional light oil production has entered a decline phase with production dropping at 3.4 percent per year since 1997; and
- Canadian natural gas production has only remained flat since 2000.

Other evidence of the maturation of Canada's most prolific hydrocarbon basin is as follows:

- capital spending in conventional assets, excluding oil sands, has doubled since 2002;
- annual drilling activity has increased 500 percent since 1992;
- the cumulative number of wells drilled in the WCSB has more than doubled in the last 13 years, but with ever-diminishing returns as production per well continues to fall;
- limited incremental conventional oil opportunities exist as annual oil drilling activities have remained flat since 2002 despite significant increases in commodity prices and capital spending in the WCSB;
- with the producing well count increasing, the average per well oil productivity has declined at 4.6 percent per year since 1994;
- the basin's conventional prospects are now predominately natural gas pools, with over 70 percent of conventional wells drilled in the WCSB targeting gas in 2005; and

- natural gas production has reached a plateau as average natural gas per well productivity has declined 9.2 percent per year since 1996.

Investors expect oil and gas producers organized as corporations to grow production. Growth is increasingly difficult in the WCSB, where new gas well production can decline as much as 30 percent in the first year. This is the so-called “treadmill” effect as oil and gas producers have to reinvest much of their cash flow just to keep production flat.

Oil and gas royalty trusts have a sustainability mandate. With a successful history of optimizing assets and increasing productivity, this model has demonstrated improved capital efficiencies over exploration and production corporations with conventional WCSB operations.

For oil and gas trusts, there is an urgent requirement to reinvest cash flow to maintain production. This is one of the major differentiators of royalty trusts from business trusts.

Energy trusts have an important symbiotic relationship within the energy industry. The oil and gas royalty trusts:

- buy and enhance mature assets from senior producers;
- are the logical buyers of juniors’ assets once they have proven up new reserves and seek to monetize value, often providing a catalyst for successful junior management teams to re-capitalize new companies, creating more economic activity;
- have injected over \$17 billion of new capital into the energy sector in the last five years, much of which has been redistributed to the other producer sub-groups in the sector;
- have themselves invested over \$15 billion in the last five years into lower risk / lower return projects aligned with the objectives of the trust’s income-oriented investor base to optimize mature fields, enhancing the ultimate recovery of Canada’s oil and gas resources; and
- have repatriated approximately \$10 billion of assets from foreign control during the past ten years. Many of these assets are being aggressively optimized by the energy trusts, providing additional production and reserves with minimal impact to the environment.

The government’s proposed tax changes would force trusts back into a corporate structure that is less efficient for mature oil and gas assets, reducing tax revenue for both provincial and federal governments.

### **Evolution of Canada’s Energy Industry**

Conventional finding and development costs are up substantially in the last five years, while unit operating costs have more than doubled. The combination of higher costs and lower production and reserve expectations has made it more

difficult for energy producers to invest profitably in the WCSB. Those factors have driven senior producers to seek their growth opportunities outside Canada, to reduce their production growth expectations in the WCSB and to pursue development of Alberta's oil sands.

Senior producers and their peers have been selling their mature WCSB properties to energy trusts, which have become expert at maximizing the resource recovery out of these mature reservoirs. With the lower cost structure and lower cost of capital that results from the alignment of unitholder objectives to the asset base and the business plan, energy trusts are able to exploit and extend mature property opportunities that would be uneconomic to other producers. This provides more oil and natural gas from existing pools without intensive capital and infrastructure development of the type required for oil sands development. From an environmental point of view, a considerable number of these mature properties conserve waste gases, utilize efficient power sources and have significant potential for greenhouse gas sequestration.

Although newer Canadian conventional hydrocarbon basins outside the WCSB are promising, they remain underexploited due to a number of factors. These include remoteness from markets, lack of infrastructure or unsettled land claims, such as is the case with the Mackenzie Valley and Delta; a lack of new discoveries, such as in offshore Newfoundland; and moratoriums on exploration such as offshore BC. Optimal recovery from the WCSB remains critical to Canada's conventional oil and gas industry.

### **Environmental Considerations**

Perhaps the most significant unintended consequence of the government's proposed tax changes relates to the environment, which is important to all Canadians. Canada's greenhouse gas ("GHG") challenges are well documented. As the WCSB has matured, ownership and control of the vast majority of Canada's legacy conventional oil reservoirs has transferred to the oil and gas trust sector. The large corporations chose not to retain control of these properties and pursue enhanced oil recovery ("EOR") activities through CO<sub>2</sub> injection, instead selling the majority of these large 'in-place' oil reserve assets to the trusts.

The oil and gas trust sector's low cost of capital and business model has allowed these projects to become more attractive economically such that trusts are now at the forefront of CO<sub>2</sub> sequestration initiatives. In two large fields alone, Pembina and Redwater, CO<sub>2</sub> EOR projects could reduce emissions of GHG to the atmosphere by 30,000 tonnes per day, or 11 million tonnes annually. These projects represent the only truly meaningful opportunities to dramatically reduce Canada's GHG emissions in the near term.

Unfortunately these projects would be targeted to come on stream around 2011, just as the government's revised tax treatment for trusts would come into effect. The proposed changes will drive energy trusts back into a corporate model.

As history has shown, this business model and a growth-oriented investor base is not aligned with the pursuit of CO<sub>2</sub> EOR projects in Alberta. At the very least these projects will be delayed but more likely many may not proceed at all.

### **Social Considerations**

Canadian energy trusts focus on optimizing existing conventional oil and gas pools. This focus on optimization extends the effective working life of mature oil and gas fields, providing continued direct and indirect economic benefits, including future employment opportunities and municipal and county taxes, to the many Western Canadian communities where trusts operate as well as to the provincial treasuries. Additionally it creates new productivity in areas with infrastructure, gas conservation and future potential for greenhouse gas sequestration.

### **Other Unintended Consequences**

Whenever major changes are made to government policies without consultation of affected parties, unintended consequences result. In this case, these include:

- massive capital losses to millions of individual investors, on the order of \$14 billion, and the associated lost tax revenue;
- reduced or lost income for millions of investors, many of whom depend on this income to live;
- a ripple effect of reduced income for economic spending and lost investment value for millions of Canadians, including charitable organizations;
- exposing Canadian corporations to leveraged buy-out groups seeking to acquire intermediate-sized corporations;
- loss of head office jobs as management control leaves the country;
- a shifting of focus from implementing improved, energy-efficient optimization methods on existing developed pools to less energy-efficient, grassroots mega projects. This in turn imposes tremendous strain on infrastructure, available labour and project costs; and
- ultimately reduced production and lower recovery of Canada's oil and gas reserves.

Without the trust structure companies will be forced to choose higher return grassroots mega projects over lower return optimization of mature fields. With the trust structure both types of projects can exist in harmony, ultimately maximizing the recovery of Canada's hydrocarbon resources.

### **Did Canada Stand Alone in its Treatment of Trusts Before These Changes?**

No. The U.S. did eliminate flow-through entities (“FTEs”) in 1987 but provided a ten-year transition period, plus life thereafter upon electing to pay a 3.5 gross income tax. This to be compared with the four years proposed in the “Tax Fairness Plan”. Further, the U.S. excluded Real Estate Investment Trusts (“REITs”) and **explicitly exempted resource industries from the measures.**

Ironically, the government’s proposed new tax will effectively eliminate the trust structure in Canada’s resource sector just as that structure expands in the U.S. Acting consistently with the U.S. would mean exempting the resource sector and providing other trusts with a ten year transition period.

### **Conclusions**

**Energy trusts are different from other trusts by virtue of their very high reinvestment requirements and their role in maintaining Canadian oil and gas production. The proposed changes will have many unintended effects, including the diminution of Canada’s energy supply.**

**Exempting energy trusts from the proposed tax changes is the only sensible course of action for this government. Failure to do so will be counter-productive to the government’s own stated reasons for acting.**

## Introduction

This report has been prepared by the members of the Coalition of Canadian Energy Trusts ("CCET" or the "Coalition"). The objective of the report is to provide background information and analysis that challenge the concerns contained in the Canadian Government's Tax Fairness Plan announced on October 31, 2006 (the "Proposals"), as they pertain to energy trusts. Also, through the provision of this information and analysis, the Coalition hopes to engage the Government in meaningful consultation to develop solutions that will address the concerns of all stakeholders.

This discussion relates primarily to oil and gas producing trusts and energy-related infrastructure and service trusts and is based on data gathered from members of the CCET, public data, and other sources noted. In this document "energy trusts" will be used to refer to all three types of energy-related trusts and "oil and gas trusts" or "royalty trusts" will be used to refer to energy trusts that produce oil and gas.

## The Coalition

The Coalition represents all 31 of the Canadian oil and gas royalty trusts and the majority of the related energy services and infrastructure trusts. We represent more than 20 percent of the oil and gas production in Canada; more than 1 million barrels of oil equivalent ("BOE") per day ("BOE/d"). Our combined market capitalization on October 31, 2006 was almost \$100 billion. The CCET members directly employ more than 8,000 Canadians and indirectly tens of thousands more.

In 2005, the oil and gas trust sector generated over 30 percent of the tax revenue collected from publicly-traded Canadian entities in the oil and gas sector while representing only 16 percent of the revenue. In 2006, we will generate payments of an estimated \$5.7 billion to governments in Canada including royalties, property and capital taxes, and the estimated \$2.4 billion in personal taxes to be paid on distributions. In 2006, energy trusts will reinvest approximately \$7 billion of capital into the Western Canadian Sedimentary Basin ("WCSB") and operating and administrative expenditures are expected to total almost \$6 billion annually. *(Source: CCET member data)*

## The Case for Consultation

In Budget 2005, the Government of Canada announced it would conduct open and transparent consultations with stakeholders on tax issues related to flow through entities. This consultation process was launched in September 2005.

In an October 26, 2005 letter to the National Post, Prime Minister Harper, then Leader of the Opposition, wrote of the liberal government:

*“So one must ask, why is the government clamping down on the retirement savings of seniors and investors?”*

*But it gets worse. Instead of immediately moving to assure markets that income trusts are here to stay, the Liberals are justifying their actions in the coldest political terms. As one government member was quoted in the media as saying about income trust investors, “They have no constituency. They don’t count politically.”...*

*That kind of arrogance cannot go unanswered. There is just no justification for what amounts to a Liberal government attack on investors, and especially on seniors. ...*

*The government claims that income trusts enjoy an unfair tax advantage over corporate dividends. If they believe this, then the answer is not to shut down a valuable investment vehicle, but to cut the double taxation of dividends. In short, level the playing field and let the market decide between income trusts and dividend-paying companies....”*

Certainly the Conservative Party’s view on income trusts at that time was clearly communicated to Canadians.

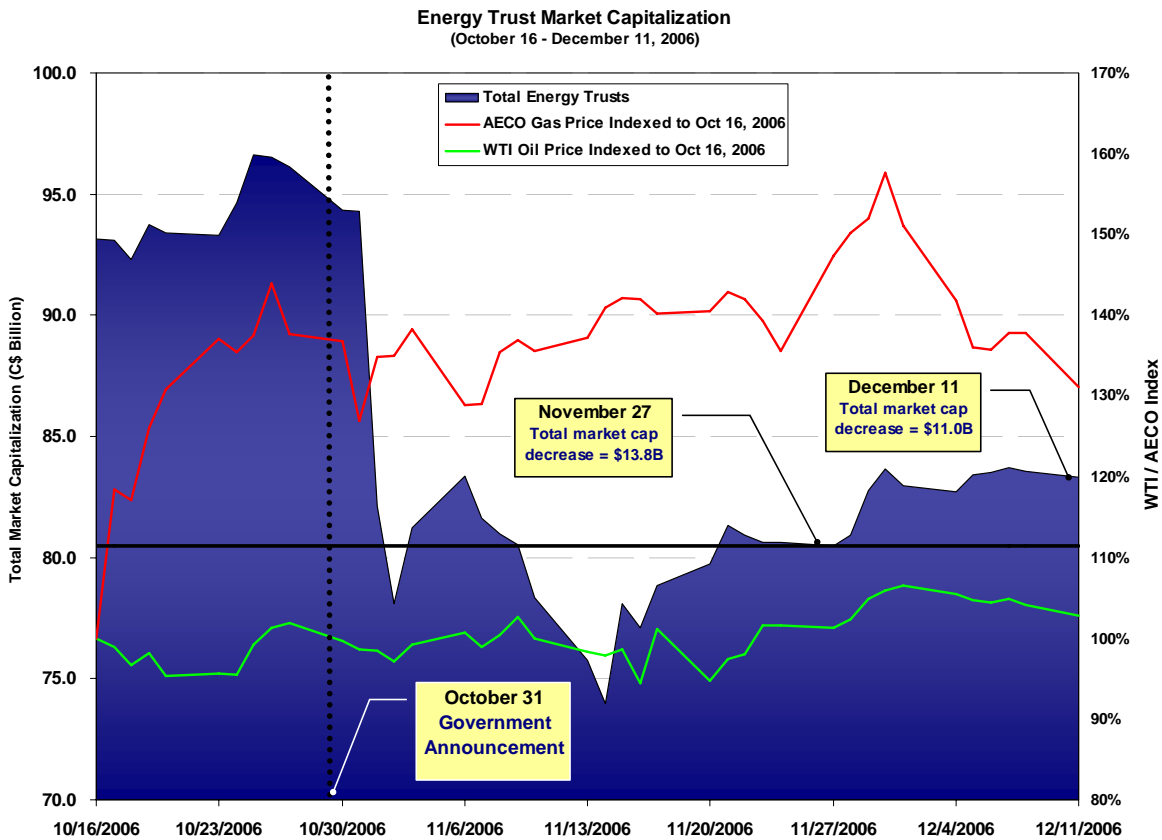
The consultation process terminated on November 23, 2005 prior to completion with the following announcement by Canada’s Finance Minister.

*“Given the uncertainty surrounding how long this session of Parliament will last, as well as the need for greater certainty and stability in the income trust market, there is a clear case for immediate action. The overwhelming consensus of submissions received in our consultation process was to reduce personal income tax on dividends,” said Minister Goodale. “Today’s announcement acts on that consensus and ends the consultation process.”*

This tax reduction proposal took the form of an enhanced dividend “gross-up” and tax credit to make the total tax on dividends received from large Canadian corporations more comparable to the tax paid on distributions of income trusts, and to reduce the “double taxation” of dividends at the federal level.

The Proposals with respect to income trusts of October 31, 2006 were announced by the Government of Canada without substantive consultation with any of the key stakeholders. Although it has been said that the concerns of the Government of Canada have changed, the Proposals have had a significant impact on the investment portfolios of millions of unitholders, the majority of whom are individual Canadians. Further, these investors relied on the results of the truncated consultation process of November 2005 and the public statements expressed by the Conservative party with respect to income trusts.

Unsuspecting investors of energy trusts effectively lost \$14 billion in market capitalization as a result of the Proposals. Certainly decisions with such an immediate impact and with a ripple effect through the economy of many times this magnitude deserve consultation. While some of the initial decline of more than \$20 billion in market capitalization has recovered, principally due to increases in oil and gas prices, there is the likelihood for additional downside should the implementation of the Proposals become more certain.



## Government of Canada Perspective

The Coalition has derived its understanding of the problem the Canadian federal government perceived it was facing from a number of sources including the following:

- The "Tax Fairness Plan" and related Backgrounder announced October 31, 2006 (attached as Appendix "A");
- The September 2005 Department of Finance Canada paper "Tax and Other Issues Related to Publicly Listed Flow-Through Entities";
- Discussions and written communication with numerous members of the Conservative Caucus including the Minister of Finance; and
- Discussions with the Department of Finance.

The stated purpose of the Proposals was to "restore balance and fairness to Canada's tax system". They were considered necessary to ensure that "our economy continues to grow and prosper" and "to bring Canada in line with other jurisdictions throughout the world". The Proposals further make several main assertions:

- Canadian tax-exempt investors, such as Canadian pensions and RRSPs, and non-resident investors, benefit inappropriately from investing in flow through entities ("FTEs") rather than a corporation;
- Trusts receive an unbalanced tax treatment that creates an economic distortion and a proliferation of income trusts that is threatening Canada's economic growth and competitiveness;
- Tax revenues are reduced as a result of the growth of the income trust sector and the overall tax burden is shifted onto the "shoulders of hardworking Canadians and their families"; and
- There is a trend toward corporate tax avoidance as corporations feel compelled to convert to income trusts.

After significant discussions with various Conservative Members of Parliament and the Minister of Finance, we have drawn the following additional conclusions regarding the reasons for the proposed change in tax treatment of income trusts:

- There is agreement that Canadian RRSPs and Pension Plans are tax-deferred investors through their conversion entities (i.e. RRIFs) and not tax exempt. It must be recognized that current tax revenues are required to pay for current services funded by the tax system.
- A concern that the tax treatment of FTEs in the hands of foreign investors versus through corporations has the potential to lead to less ultimate tax revenue being collected from the activities of Canadian companies due to a lower rate of tax on the foreign investor. For non-resident unitholders, income distributions from trusts are subject to a 25 percent withholding tax. This withholding tax is generally reduced under Canada's bilateral tax

treaties; often to 15 percent as is the case under the Canada–U.S. tax treaty. The government’s concern is that the relatively low cost of capital created by the attractive aspects of the trust structure is “expensive” to Canada from a tax loss perspective, particularly with respect to foreign investors who are perceived to be less likely to reinvest their income in Canada.

- Given the attractive after-tax return that foreign investors enjoy, particularly relative to their other investment options, the marginal buyers for trust units are foreign and tax-deferred Canadian investors. Therefore the concern is that trust unit ownership by these investors will continue to trend higher. This will, in turn, cause current tax collected on income from distributions to be reduced over time on a percentage of distribution basis. This could lead to less investment in the Canadian economy and less revenue available to the federal government for investment in services for Canadians.
- Despite the actions taken by the Government in the 2006 Budget to increase the dividend tax credit for taxable Canadian investors to create equivalent treatment of corporate dividends compared to trust distributions, there is no indication that the trend of Canadian businesses to convert from corporations to income trusts has been reversed. The concern is that if the majority of Canadian businesses ultimately convert to the income trust structure, Canadian business will be dominated by foreign and tax-deferred ownership and government revenues through current taxes directly from the activities of Canadian businesses will be reduced significantly, thereby shifting the burden to “hard-working Canadians”.

## **Energy Trust Perspective**

Through discussion with various Conservative Members of Parliament including the Minister of Finance, members of the coalition were assured that it was not the intention of the government to abolish the trust sector, as currently outlined. However, the Proposals will result in the effective near-term destruction of the oil and gas trust model, regardless of the four-year transition period. Our industry requires continuous and cost-effective access to capital, both Canadian and foreign, to continue to replace and enhance our depleting reserves. The entire industry relies on the energy trust sector’s access to capital. The Proposals will reduce access to such capital as income-seeking investors will no longer be sufficiently induced to invest.

As the energy trust sector is the *de facto* mid-cap oil and gas sector and primary exploiter of mature assets in Canada, the potential impact on the future development of Canada’s strategic conventional energy resources cannot be understated. Further, the Proposals put at risk Canadian “mind and management” control of a significant portion of the conventional energy industry.

In an effort to create a “level playing field”, the Proposals also put at risk beneficial relationships between:

- Trusts and senior energy corporations;
- Trusts and high growth, smaller exploration companies;
- Investors, both Canadians and foreign; and
- Canadians with individual retirement plans and members of large group pension plans.

Our key responses with respect to the Government of Canada’s key concerns are as follows:

- The trust structure is the appropriate business structure for the mature oil and gas assets owned by energy trusts since it leads to efficient development of Canada’s strategic energy resources. As long as there is no reduction in the absolute amount of tax to be paid and the timing of cash flows to the government are matched with the government’s required spending programs, differences in the timing and form of taxation should be acceptable. This is especially the case since the Government has recently announced a budget surplus. Different tax treatments attract different investors with different priorities.
- The Department of Finance refers to RRSPs, RRIFs and pension plans as “tax exempt” and discounts any current or future tax revenue in their calculations. Tax-deferred retirement accounts act like a huge savings account for the government and serve to increase government tax revenues overall. Compound growth essentially expands the tax base of these plans over time, while the deferred tax of the contributions in any given year is offset by taxes collected on the withdrawals from prior years’ contributions in any given year. Moreover, Trust distributions which would otherwise be non-taxable to a direct investor are fully taxed when paid out of a deferred plan. The tax base today includes current tax revenue from contributions made to such plans in the past just as future government tax revenues will benefit from current contributions and their compounding reinvestment within these entities. These accounts are not tax-exempt and, in fact, contributed \$52.5 billion to tax revenues through withdrawals in 2004.
- The majority of Canadians do not have access to a defined benefit pension program. Energy trusts allow individual Canadians to participate in and derive benefits from investing in Canada’s resource sector in a tax-deferred manner. Without an energy trust sector this type of investment opportunity would only otherwise be available to a small subset of Canadians such as institutions and wealthy investors and to private equity investors.
- Energy Trusts generate significant current income taxes;
  - More than the taxes generated currently from these assets as compared to when they resided in the corporate structure; and
  - Almost double the taxes paid by corporations on a relative basis.The estimated average tax rate on corporations is 10 percent of earnings before interest, taxes, depletion, depreciation and amortization (“EBITDA”), while for trust distributions the estimated personal tax rate is 18 percent of

EBITDA (Source: BMO Capital Markets). Whether an investor chooses to pay the tax directly as a trust unitholder or indirectly as a corporate shareholder makes no difference from a tax perspective. The investor should decide.

- Tax-deferred investors currently experience double taxation on corporate dividends and the Proposals will subject Trust distributions to even more punitive double taxation. Historically, dividends in the corporate resource sector have been very low as the tax system incents capital reinvestment not income distribution. Existing energy trusts do not contribute to an increasing trend in corporate tax avoidance. Foreign investors of energy trusts provide a significant contribution to the Canadian tax base. Foreign investment in Canada is significant to our prosperity as a nation. Canadian taxes assessed on foreign investors need to take into account the fact that they will pay tax in their home jurisdiction and that they are not utilizing services and infrastructure that the Canadian tax system is designed to fund.
- The Canadian energy industry has always relied on foreign investment to exploit its abundant resources. This continues today in conventional production through energy trusts and in unconventional (i.e. oil sands) production through senior producers many of which are either 100 percent foreign-controlled or Canadian companies which are predominantly foreign-owned. Foreign investors in energy trusts are subject to immediate taxation on distributions through withholding at rates ranging from 15 to 25 percent. Most foreign-controlled senior producers have historically paid minimal corporate taxes and modest dividends.
- Provincial tax leakage while it does exist for provinces like Alberta since greater than 75 percent of units in CCET member companies are owned outside of Alberta and all of the energy trusts are headquartered in Alberta. As a result, all provincial jurisdictions, especially Ontario and Quebec, currently receive tax revenue generated by western Canadian resource revenue. While tax leakage does exist, it is offset by benefits to Alberta including increased royalty revenue, spending on goods and services, employment and the other ancillary spin-offs from that economic activity which would not exist in the absence of the trust sector. Implementation of the proposed government tax changes would divert all of these provincial taxes, hundreds of millions of dollars annually, back to Alberta at the expense of the other provinces.

Millions of Canadians have been hurt by the Proposals of October 31, 2006. There are alternative solutions to the government's concerns that can more fairly meet the concerns of all stakeholders.

## Overview of the Canadian Energy Sector

There have been indications from the Government that the “playing field” had to be levelled to eliminate the trust sector’s cost of capital advantage over corporations. This view does not have validity in the oil and gas sector. There are three distinct sectors in the Canadian energy industry, each “playing in a different field”:

- Junior E&P companies with production up to 10,000 BOE/d;
- Intermediate sector with production of 10,000 BOE/d to 100,000 BOE/d. This sector is now almost entirely operating under the trust structure; and
- Senior producers with production in excess of 100,000 BOE/d.

The junior sector is made up of more than 400 public and private companies which collectively contribute only 10 percent of Canada’s reserves and production. Many of these companies are very small and, on a relative basis, not very active drillers. A vibrant sub-group of this sector is very actively growing their reserves and production and a close relationship has developed between the trust sector and these growth-oriented junior companies including:

- farming in on trust lands considered too risky for the trust to pursue;
- using corporate dispositions or conversion to a trust as an exit strategy; and
- with this exit strategy in mind, management of these juniors focused on short-term growth of the asset base without having to create the organizations required to run them in the long term.

The energy trust sector is currently made up of 31 oil and gas producers, 11 infrastructure and pipeline trusts and 18 energy services trusts. The sector has evolved from “financial managers” of non-operated oil and gas assets 10 years ago to actively managed oil and gas production and development entities today. The sector is 100 percent Canadian managed and operated with less than 50 percent aggregate foreign ownership and a much larger “retail” investor base than the juniors or seniors.

The vast-majority of assets owned by the trusts have come from the following areas:

- conversion of a growth-oriented junior company which reached the limits of its ability to efficiently grow their business;
- acquisition of a junior exploration and production company which was seeking to monetize its value and often re-start the cycle with a much smaller production base upon which to build; and
- acquisition of assets from senior producers seeking to monetize value on non-core properties.

Energy trusts tend to be focused in western Canada with a small but growing component of foreign assets.

The senior producer sector is made up of less than twenty companies which collectively produce approximately 65 percent of Canada's conventional production and over 85 percent of unconventional production. The sector comprises wholly-owned subsidiaries of foreign corporations or Canadian corporations with foreign ownership materially greater than 50 percent. Most of these companies are active internationally, in the oil sands or in the frontiers either directly or through their parent companies. On average, these companies are as much as 10 times larger than the average trust and therefore have significant economy of scale advantages. Even with oil sands and international options, the senior producers are challenged to grow as evidenced by EnCana Corp.'s recent announcement that they are lowering their growth targets and increasing their share buy back program.

Companies operating in each of these three sectors have distinct advantages and disadvantages relative to the other sectors. The junior sector is characterized by small and "nimble" companies with a small base of production upon which to grow and lean organizations in terms of manpower requirements. Exponential growth is achievable even with the reduced size of exploration targets available in the WCSB.

The intermediate or trust sector has fully developed organizations focused on sustainability through exploitation and optimization of large mature properties either too large for the junior sector or with near-term capital requirements too great for the junior companies. At the same time these mature properties generally do not have high impact opportunities thus senior producers have no interest in these non-core assets.

The trust sector has been able to attract new investors seeking income into the energy industry. These investors have lower return requirements relative to the traditional investors in the industry and this has resulted in a low cost of capital for the trust sector (discussed later in this report) which is shared with the other players in the sector principally through property acquisition transactions.

The size of the senior producers provides significant economies of scale advantages not available to the junior or trust sectors. This affords the opportunity to invest internationally or in oil sands mega-projects which are only available to trusts on a limited basis and essentially unavailable to the junior sector. To suggest that all businesses operating in the energy sector should be on a "level playing field" does not recognize the realities of the industry, its diverse capital and operating requirements or the valuable and unique roles played by the different groups operating in the industry. (See "Industry Interdependence").

# Overview of the Canadian Royalty Trust Sector

## Evolution of the Royalty Trust Sector

The Canadian oil and gas royalty trust sector got its start in 1986 with the creation of Enerplus Resources Fund by Marcel Tremblay. The initial concept was to provide individual investors with an opportunity to invest directly in oil and gas assets through the creation of a mutual fund which would own working interests in a diverse group of oil and gas properties. Previously such investment opportunities had only been available to large institutional or high net worth individuals. The entity was quite similar to a mutual fund with an external manager paid a management fee and the benefits of ownership flowing through to the individual investor. From 1986 to 1995 a few trusts were created, such as Petrofund Energy Trust, Pengrowth Energy Trust and the Westrock Income Funds, which had a combined market capitalization at the end of 1995 of only \$0.6 billion. These early trusts were originally passive investment vehicles; financially managed, non-operated entities.

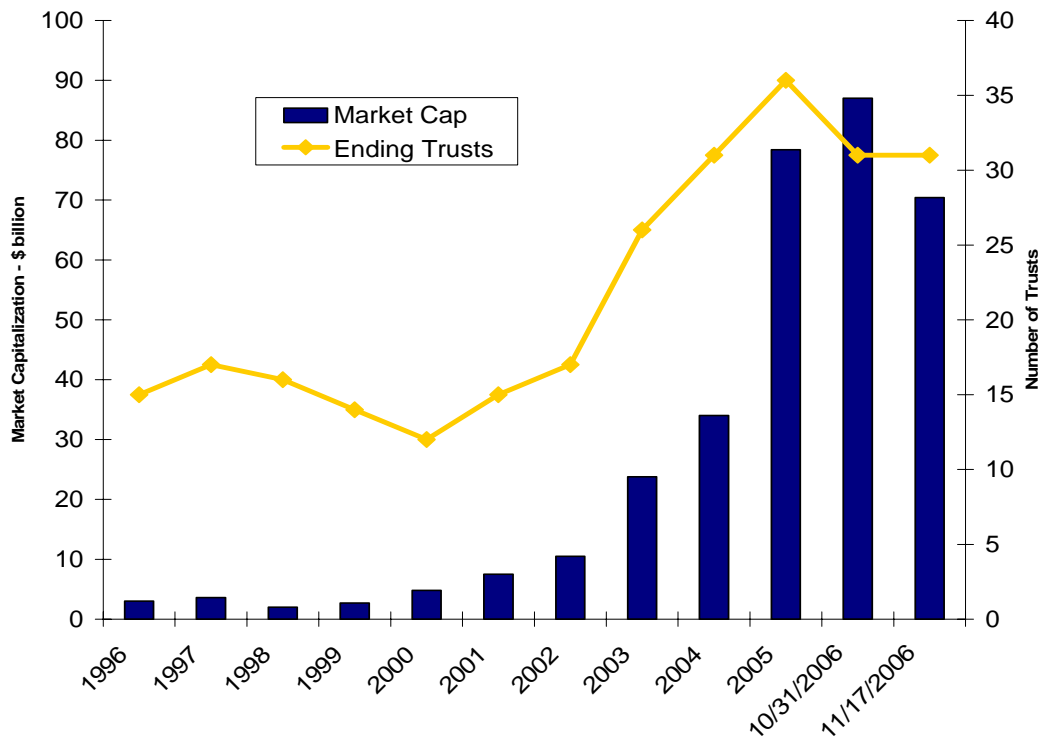
In recent years the structure has evolved into actively managed businesses creating significant value for the economy and investors. The market changed dramatically in 1996 when \$1.3 billion of equity was raised through nine initial public offerings of royalty trusts and the first conversion of an “E&P” company, Mark Resources, into a royalty trust (EnerMark Income Fund). This remarkable increase was primarily the result of the following two factors:

- the equity markets growing demand for income products at a time of falling interest rates; and
- the maturing of the WCSB meant that senior and intermediate companies were looking to sell their western Canadian properties to invest internationally. The average return on capital employed by the oil and gas industry in western Canada during the early 1990’s was less than 5 percent.

By the end of 1997, there were 17 conventional royalty trusts in existence with a market capitalization of \$3.2 billion. Following this growth spurt, a consolidation phase emerged as the commodity markets experienced a sharp decline with oil prices falling to \$12 per barrel. By the end of 2000 there were only 12 trusts remaining.

This period also marked the disappearance of many intermediate and senior Canadian oil and gas producers through corporate takeovers such as Rio Alto Exploration, Renaissance Energy and Crestar, culminating with the \$2.6 billion purchase of Poco Petroleums by Burlington Resources. By the end of 2001, Gulf Canada Resources, Anderson Exploration, Canadian Hunter Exploration, Berkley Petroleum and Encal Energy Ltd., had all been purchased by U.S. companies in a \$20 billion takeover binge.

## Oil and Gas Trusts and Market Capitalization



Source: Scotia Capital

The first material wave of conversions of junior and intermediate E&P companies into oil and gas royalty trusts also took place in 2001. Management teams realized the difficulty of growing their production base exclusively in a mature basin and opted to convert to a trust to meet the market demand for energy trust investment product. This conversion trend continued through to the end of 2005 when the trust market had grown to a total of 36 trusts. The combination of an ever increasing need for income product in Canada and a maturing sedimentary basin which presented significant challenges for the typical growth model has resulted in virtually the entire mid-cap sector of the industry converting to a sustainability model. It should be noted that many of the conversions led to the spin out of small junior E&P companies.

The Canadian oil and gas sector had effectively split into three distinct groups:

- junior oil and gas exploration companies who are valued for their ability to grow;
- oil and gas trusts who are valued for their ability to generate income; and
- senior oil and gas exploration and production companies who are valued for their ability to grow through investment in large-scale, capital-intensive projects.

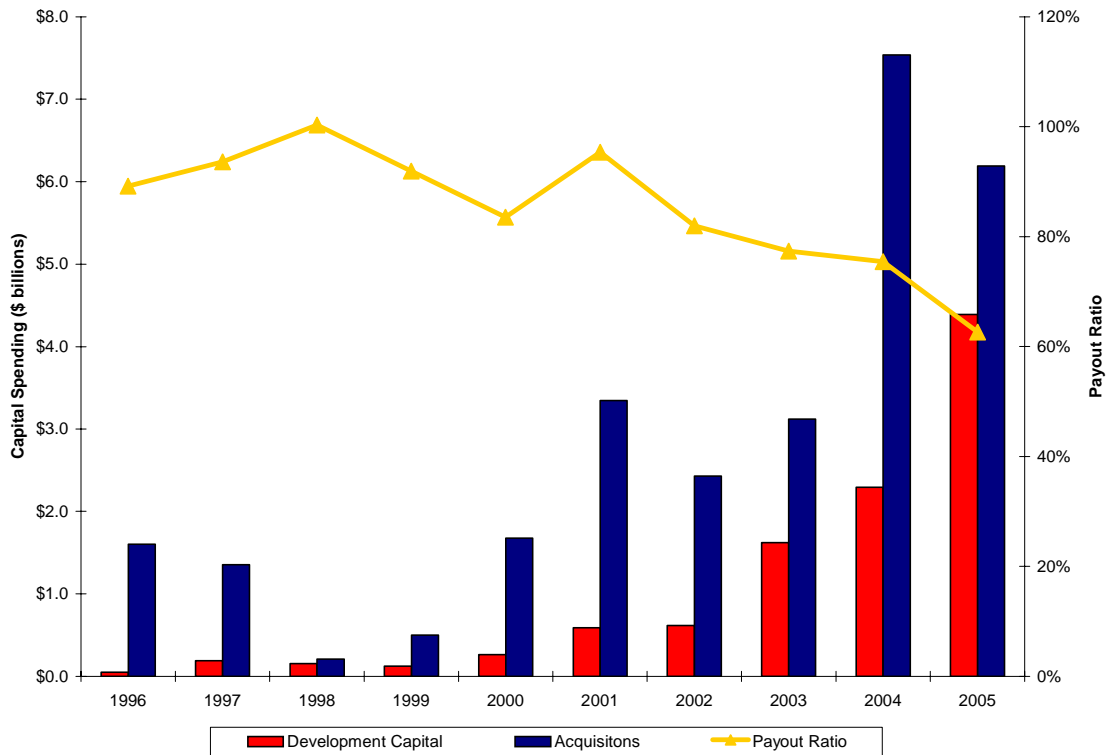
At the same time the trust sector continued to transform, driven by feedback from the investment community. External fee-based management companies were disbanded for internally-owned management to ensure alignment of management with unitholders. Provinces such as Ontario and Alberta passed limited liability legislation to protect Unitholders from the inherent risks of asset ownership. The financially-engineered acquisition asset blow down and cash yield driven model evolved to a sector seeking a balance between sustainable production reserves and distributions on a per unit basis with payout ratios related to the inherent cost of maintaining production.

## **Current State of the Royalty Trust Sector**

The last two years has seen some consolidation activity within the royalty trust sector so that as of October 31<sup>st</sup>, 2006 there were 31 conventional oil and gas royalty trusts with a market capitalization of just under \$100 billion. While there has been strong growth in the trust sector, the vast majority of Canada's production remains in the hands of the large Canadian and foreign integrated oil and gas companies. Only one trust is found amongst Canada's top ten oil and gas producers.

While many people assume that royalty trusts distribute "all" of their cash flow, royalty trusts have evolved to a sustainability model where, on average, approximately 60 percent of cash flow is distributed and the remainder is reinvested in capital activities to arrest production declines and reserve depletion. Contemporary oil and gas royalty trusts are very similar to oil and gas companies with the primary difference being that trusts spend only a small amount of capital on exploration while focusing the majority of is capital programs on lower risk exploitation, optimization and development.

## Oil and Gas Trusts Capital Spending and Payout Ratios



Source: Scotia Capital

The sector is a significant and active developer of oil and gas assets. In 2005, trusts spent \$3.8 billion on development activities and drilled 5,431 wells (2,335 net) or approximately 25 percent of all wells drilled in western Canada. In the first three quarters of 2006, trusts had spent \$5.7 billion on development activities and drilled 4,850 wells (2,194 net). (Source: CCET member data)

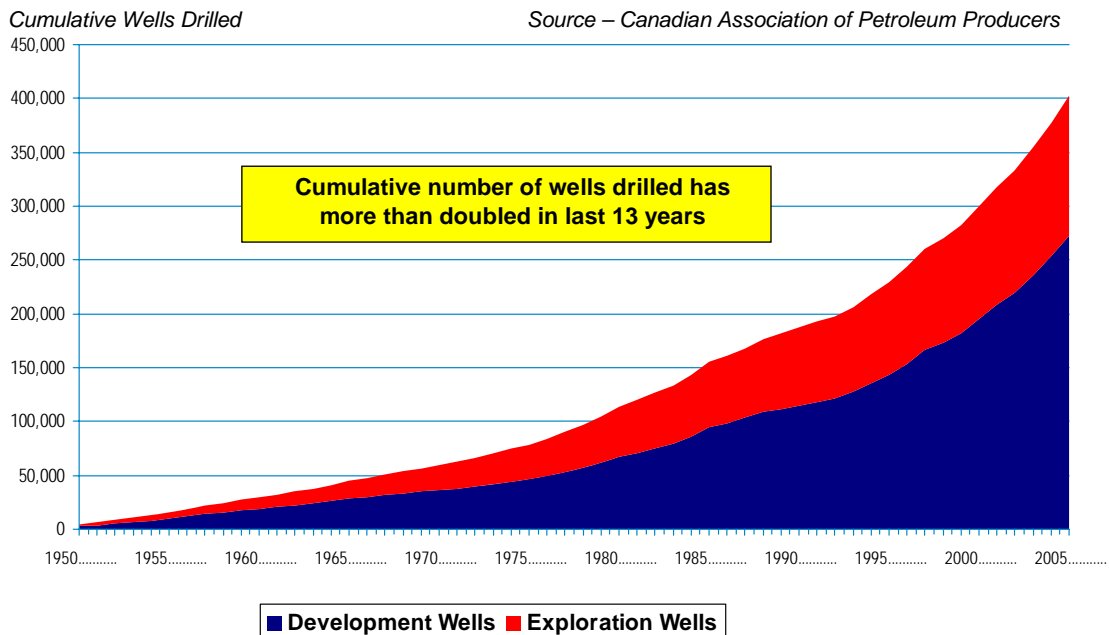
# The Important Role of Canadian Energy Trusts

## Basin Maturity

The WCSB has matured rapidly in the last 10 years. There may still be large undiscovered fields in the Mackenzie Valley and far north and with deep targets in the foothills. However in the main fairway of the basin the vast majority of the pools of conventional crude oil and natural gas remaining to be discovered are relatively small. Aside from major non-conventional projects such as oil sands mining, steam assisted gravity drainage (“SAGD”) other thermal recovery projects, and coal bed methane (“CBM”) and Deep Basin tight gas resource plays, the emphasis in western Canada is now on extending the life of existing fields by pursuing better extraction techniques.

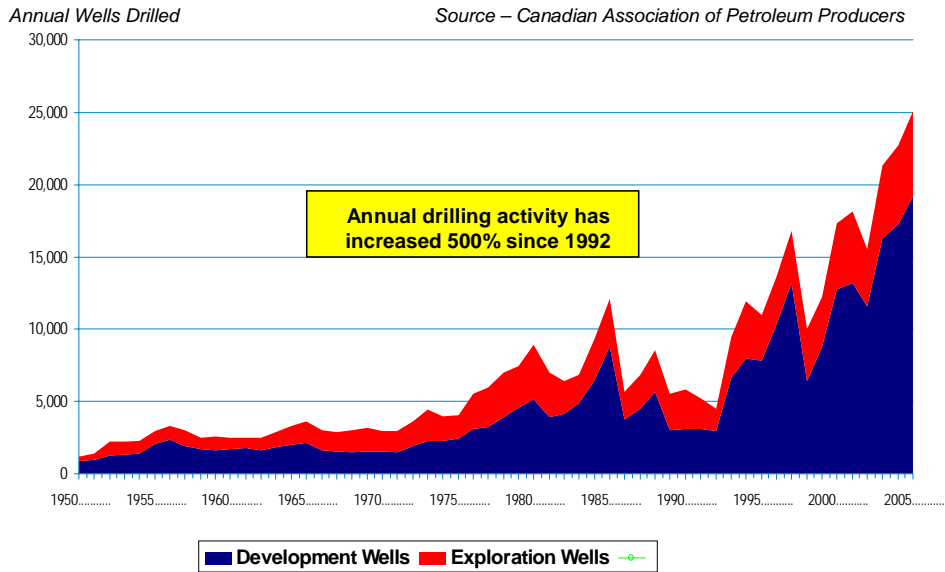
As evidence of the rapidly maturing WCSB, the cumulative number of wells drilled in the basin has doubled in the last 13 years.

### Western Canadian Sedimentary Basin A Mature Basin With Conventional Production In Decline



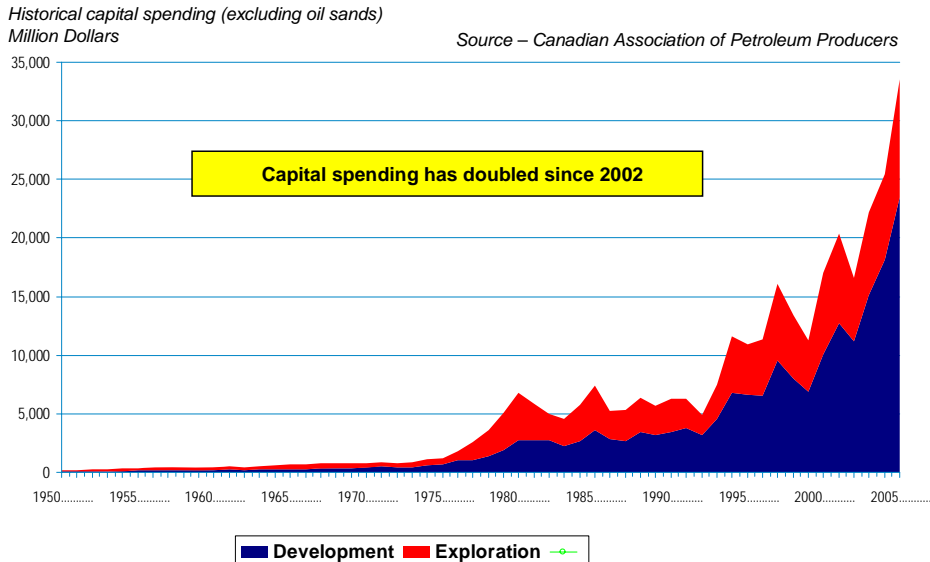
Average annual conventional production declines in the WCSB are estimated to be approximately 25 percent per year which means roughly 1.3 million barrels of oil equivalent per day must be developed just to maintain current production levels. To meet this need, annual drilling activity has increased sharply.

**Western Canadian Sedimentary Basin  
A Mature Basin With Conventional Production In Decline**



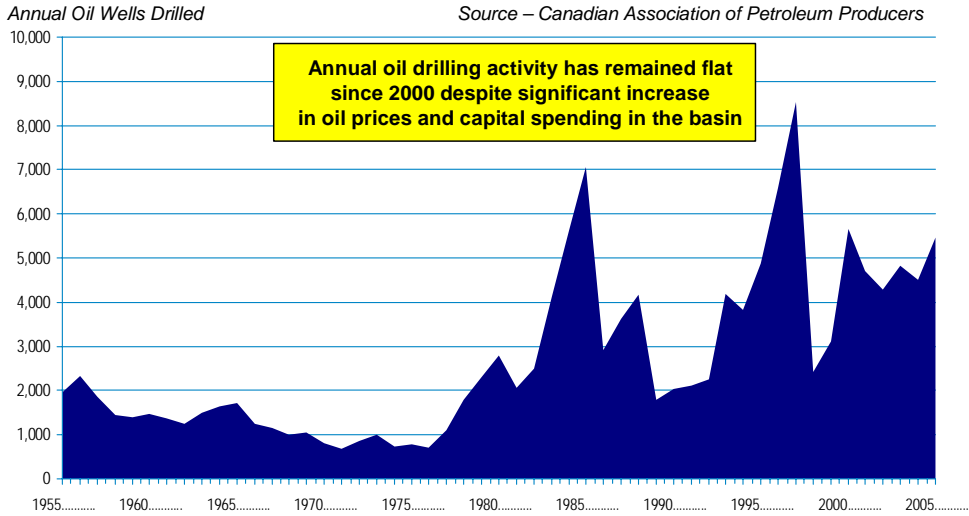
The increase in commodity prices which has occurred in recent years has led to record levels of capital spending as operators seek to replace production and continue to grow. Capital spending (excluding oil sands) has doubled since 2002.

**Western Canadian Sedimentary Basin  
A Mature Basin With Conventional Production In Decline**



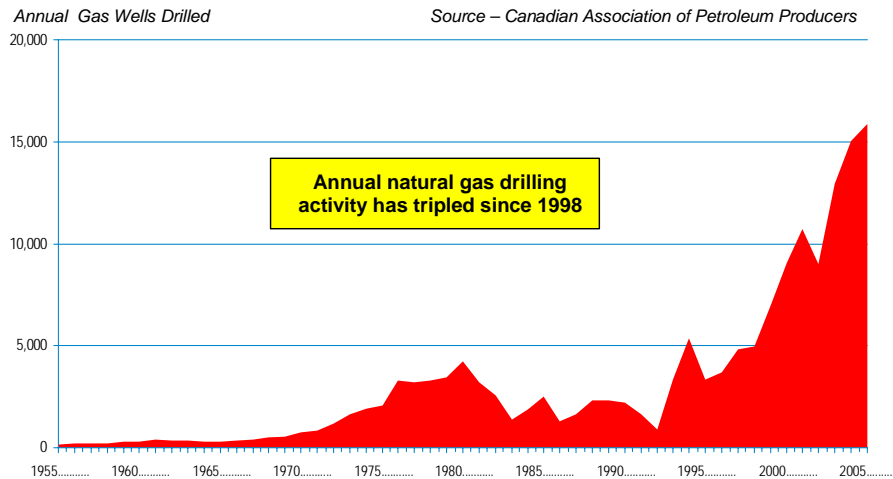
The WCSB is a gas prone basin. Therefore, despite the significant increase in capital spending, annual oil drilling activity has remained essentially flat since 2000. This level of oil well drilling activity is indicative of a basin with limited incremental conventional oil opportunities.

**Western Canadian Sedimentary Basin  
A Mature Basin With Conventional Production In Decline**



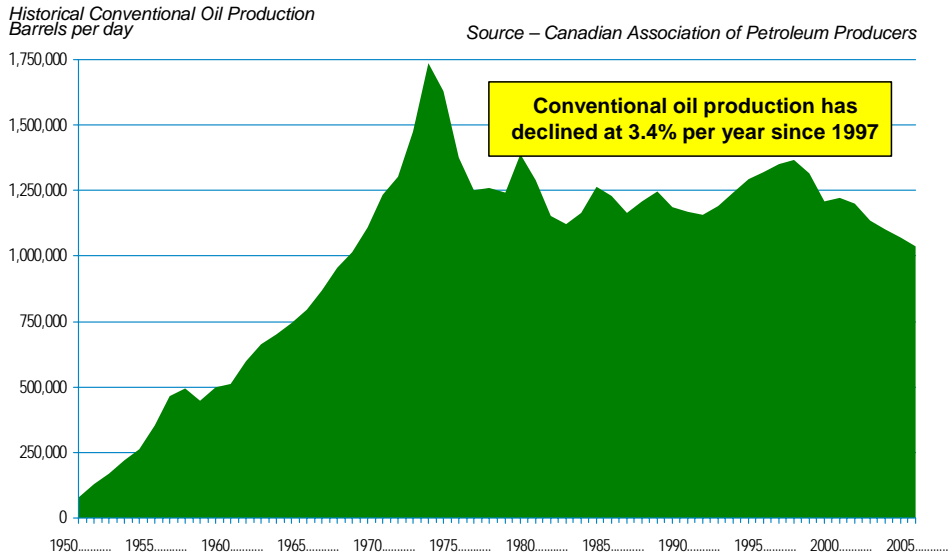
Conversely, natural gas drilling has tripled since 1998. A significant component of this drilling activity has been related to infill drilling in existing fields as opposed to developing new fields.

**Western Canadian Sedimentary Basin  
A Mature Basin With Conventional Production In Decline**



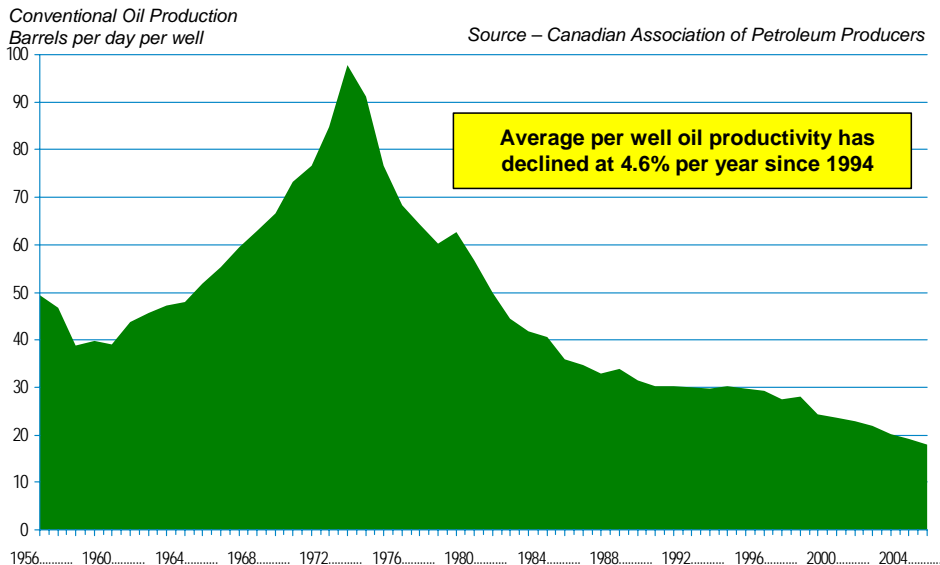
Despite the record levels of capital spending and annual drilling, conventional oil production is declining and natural gas production has only remained flat. Oil well drilling has been essentially unchanged since 2000; however, conventional oil production has declined an average of 3.4 percent per year since 1997.

**Western Canadian Sedimentary Basin  
A Mature Basin With Conventional Production In Decline**



With the ever increasing well count and declining conventional oil production, the average per well productivity has declined an average of 4.6 percent per year since 1994. Conventional oil has entered a terminal decline phase in the WCSB.

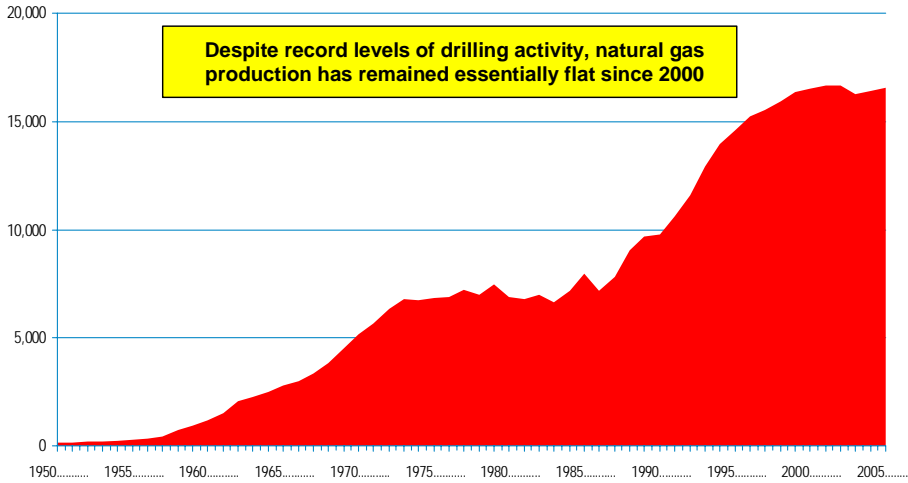
**Western Canadian Sedimentary Basin  
A Mature Basin With Conventional Production In Decline**



With respect to natural gas, despite record levels of drilling activity, production has remained essentially flat since 2000.

**Western Canadian Sedimentary Basin  
A Mature Basin With Conventional Production In Decline**

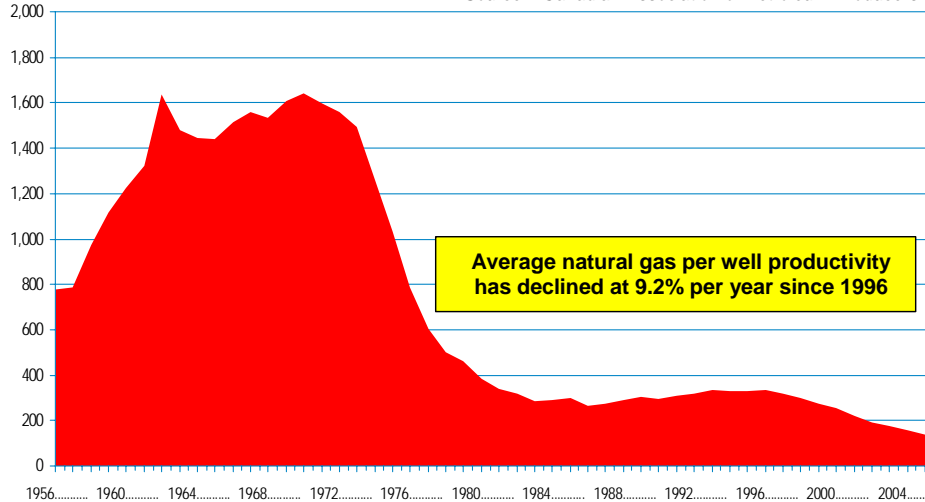
Natural Gas Production  
Million cubic feet per day  
Source – Canadian Association of Petroleum Producers



As was the case for oil, the average natural gas per well productivity is declining sharply at 9.2 percent per year since 1996. Conventional natural gas production in the WCSB has reached a plateau and will likely begin to decline in the near future. Lower rate of return projects such as CBM will be required to allow overall gas production to be maintained in the near term.

**Western Canadian Sedimentary Basin  
A Mature Basin With Conventional Production In Decline**

Historical Natural Gas Production  
Thousand cubic feet per day per well  
Source – Canadian Association of Petroleum Producers



There are significant operational implications in relation to the mature nature of the WCSB. Overall oil production continues to grow as a result of expansion of oil sands operations. However, these mega-projects are the domain of senior producers, both foreign and domestic, and are beyond the capital capacity of the majority of companies operating in the WCSB. Unconventional natural gas projects such as deep basin tight gas, coal bed methane, etc., will need to be expanded to offset declining conventional natural gas production. Northern Canada exploration and infrastructure is also needed to further maintain Canada's reserve and production base.

## **Evolution to a Sustainability Model**

The business model for oil and gas corporations is to grow production and hence per share value through re-investment of cash flow. In a basin such as the WCSB with declining conventional production, all companies cannot be successful as growth entities without a high risk exploration and / or unconventional component. Since significant unconventional projects are beyond the reach of most companies, the historic growth model will not work on a continuous basis for most companies.

The oil and gas trust model has evolved in the last ten years as the WCSB has matured into a sustainability model with reinvestment averaging approximately 40 percent of cash flow to maintain reserves, production and distributions. Opportunistic acquisitions are required from time to time to replenish development opportunities, offset declines or grow production.

Overall rising industry cash flows coincident with a rapidly maturing sedimentary basin have resulted in deteriorating capital efficiencies for many oil and gas companies operating in the WCSB. A corporation's mindset is to reinvest cash flow to grow their business. As cash flow has risen sharply and the basin has matured, efficient deployment of this capital has become a significant challenge. Finding, development and acquisition ("FD&A") costs are defined as total capital expenditures divided by barrels of reserves added over a specified period. FD&A costs for the companies operating in western Canada have risen 18 percent on a compound annual average basis since 2002 (*Source: FirstEnergy Capital, Finding, Development & Acquisition Cost Analysis, August 2006*).

## **Capital Efficiencies**

The "tyranny of growth" which exists in a corporate structure is absent in the trust model as sustainability is the primary objective for the oil and gas royalty trust sector. In a declining basin, sustainability is also a challenge. However, it is much more achievable than continuous growth.

In a sustainability model, trusts are more focused on extracting maximum value from existing mature assets through increased optimization activities. They

create significant productivity and efficiency enhancements by investing heavily in development drilling, new recovery technologies and engineering processes. The energy trusts have become experts in extraction techniques, employing new technology to optimize production, reduce operating costs, and extend the life and productive capacity of mature properties.

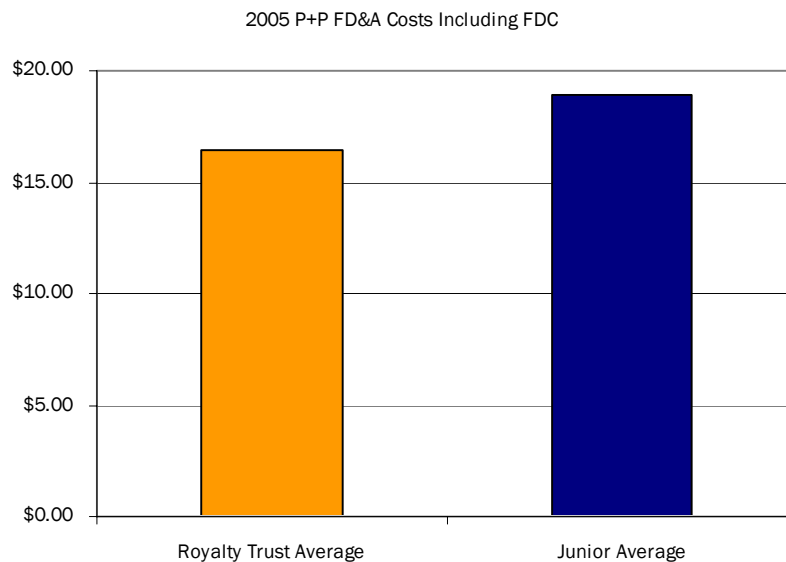
The discipline required to make regular distributions leads to more efficient capital investment decisions and, in many cases, better capital efficiencies. Lower FD&A costs are an indication that reserves are being added less expensively and therefore more efficiently.

According to an industry study by Canaccord Adams, in 2005, the proved plus probable FD&A costs for the royalty trust sector were less than the FD&A costs for junior oil and gas producers. This is due to the juniors' tendency toward more costly exploratory drilling in hopes of higher returns.

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**Finding, development and acquisition cost comparison**

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Source: Canaccord Adams

Capital efficiencies improve in the trust sector as a result of:

- Increased production optimization and development activities on existing assets. These relatively low cost / low impact activities are meaningful for a trust with a sustainability model but less attractive to large corporations that are seeking growth.
- The benefit of time to stage capital spending thereby staging risk, decreasing the risk capital exposure thereby increasing the probability of success of capital spending activities.
- Reduced exposure to higher risk exploration activities;

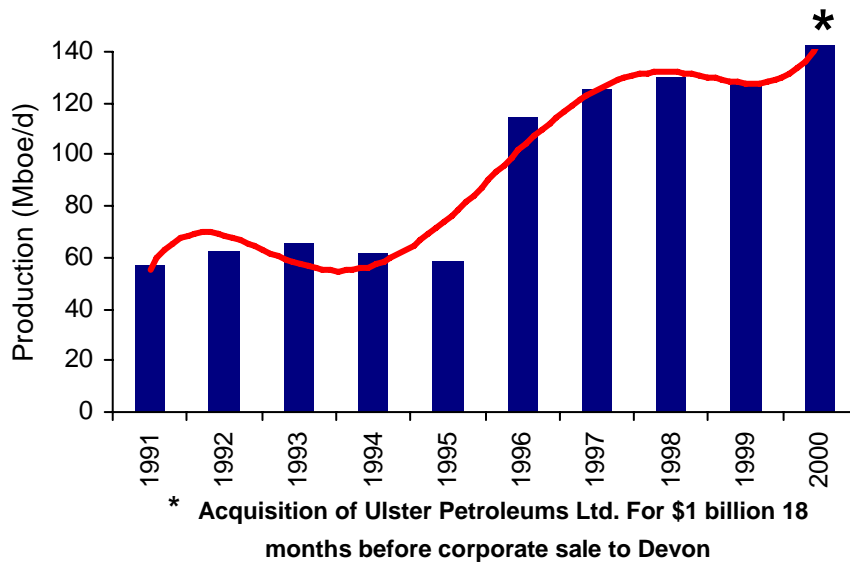
- Greater utilization of existing infrastructure. Sustainable development results in lower peak production volumes sustained over a period of time which results in less potential for over building facilities and capital inefficiencies.
- The requirement for making monthly cash distributions imposes significant spending discipline on an organization.

## **The Demise of the Intermediate Canadian Oil and Gas Sector**

Small and intermediate companies operating exclusively in the mature portion of the Canadian energy business will often “hit the wall” in terms of production and reserve growth. In essence, the larger they become, the more difficult it is to grow in a profitable manner. As growth plateaus, capital efficiencies are eroded as the companies attempt to fully reinvest cash flow. Since their investor base expects growth, once they begin to stagnate they lose their following in the equity markets and their share price drops making them takeover candidates. Further, as smaller exploration companies reach a certain size the entrepreneurial skills of the founding management are often better suited to return to a smaller exploration-focused organization. The trust structure provides Canadian companies with an option to convert to a sustainability model and migrate to an investor base that is aligned with that model.

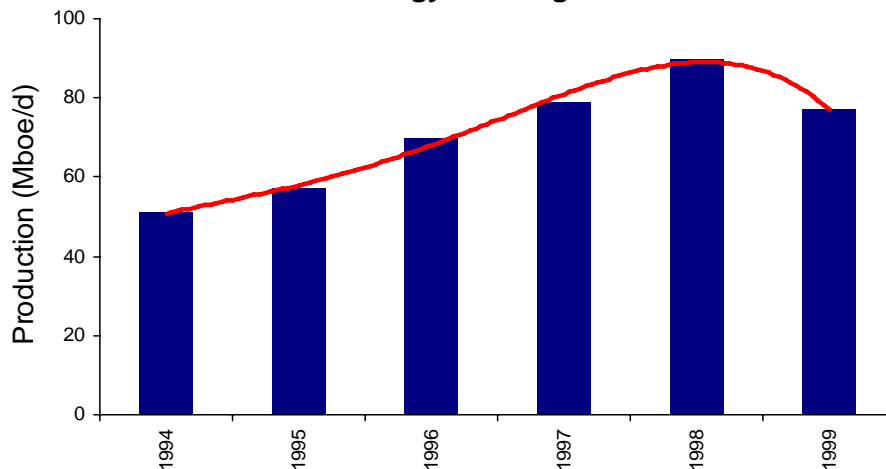
Prior to the growth of the royalty trust sector, companies that “hit the wall” were normally taken over by another company, often foreign-controlled. For example, Anderson Exploration’s production was basically flat for four years prior to their purchase by U.S. based Devon Energy in 2001.

### Anderson Exploration – Hitting the Production Wall



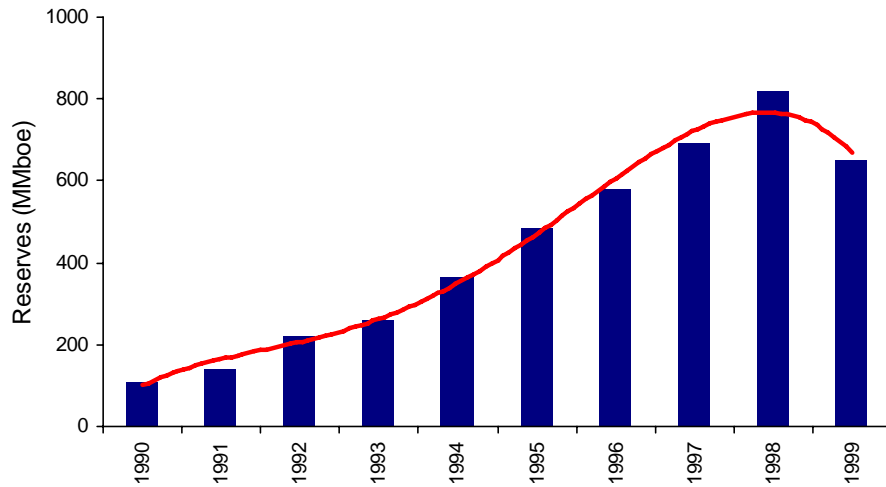
Similarly, Crestar Energy’s production had begun to decline in 1999 prior to its acquisition by the predecessor to ConocoPhillips.

### Crestar Energy – Hitting the Production Wall

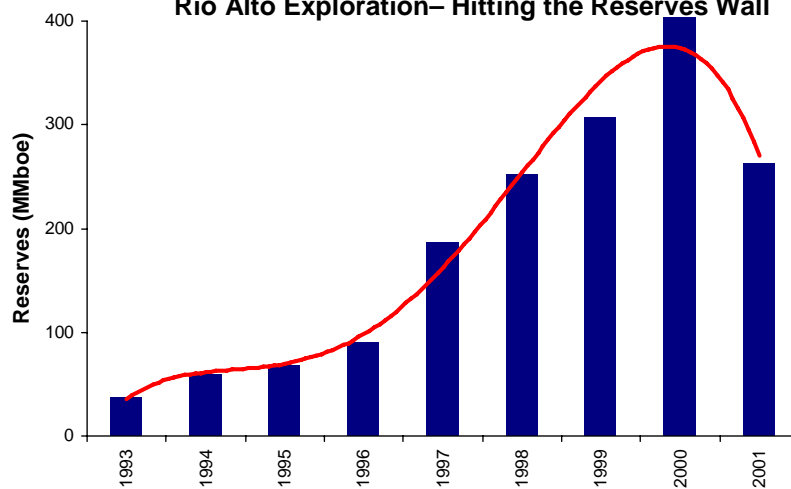


Renaissance Energy and Rio Alto Exploration saw their reserves begin to decline in 1999 and 2001 respectively prior to takeovers by Husky Energy and Canadian Natural Resources.

**Renaissance Energy – Hitting the Reserves Wall**

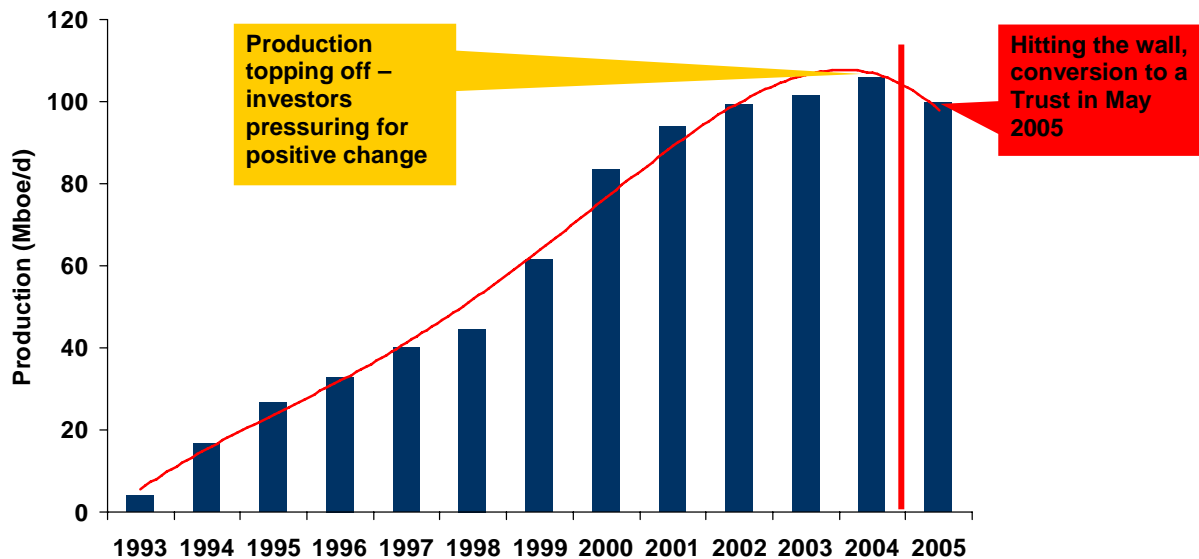


**Rio Alto Exploration – Hitting the Reserves Wall**



Penn West Petroleum Ltd. (“Penn West”) was a very successful junior E&P company that grew production from less than 5,000 BOE/d in 1993 to 99,500 BOE/d in 2002. Despite spending 95 percent of cash flow for the next 36 months, they were only to grow to 105,800 BOE/d. When Penn West was unable to grow production the company chose to convert to a trust rather than being acquired at a share price that did not reflect their value.

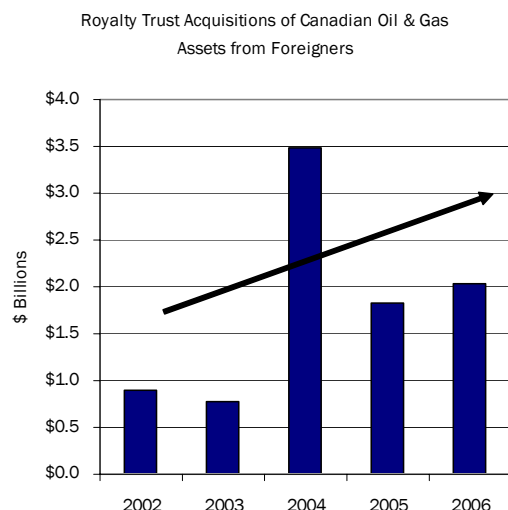
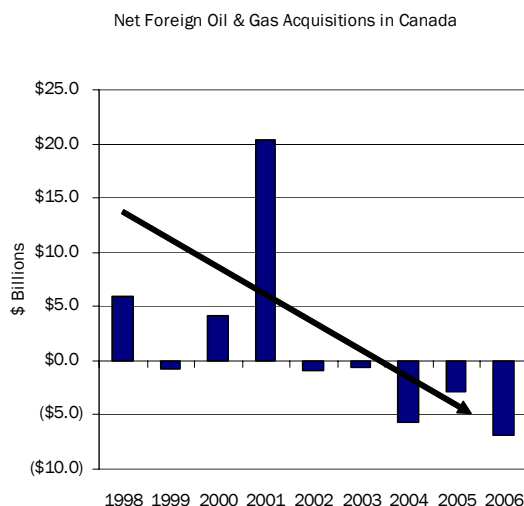
### Penn West – Hitting the Production Wall



### Repatriation of Canada’s Resources

Before the emergence of the trust sector, many of Canada’s intermediate oil and gas companies were being acquired by international corporations, predominantly from the U.S.

The expansion of the Canadian energy trust business halted this tide of foreign takeovers and has actually reversed the trend. In the five years ended 2005 trusts purchased over \$8.9 billion of oil and gas properties from foreign-owned corporations. Pengrowth’s recent acquisition of assets from ConocoPhillips will push this total close to \$10 billion.



Source: Canaccord Adams, Company Reports, Financial Post, Sayer Securities

As a result of this repatriation, head offices and the key decision making functions remain in Canada. Decisions surrounding capital investment, jobs, safety, and the environment are driven by Canadians.

## Industry Interdependence

In a basin such as the WCSB, with declining total conventional production; all companies cannot be successful as growth entities without an unconventional production component.

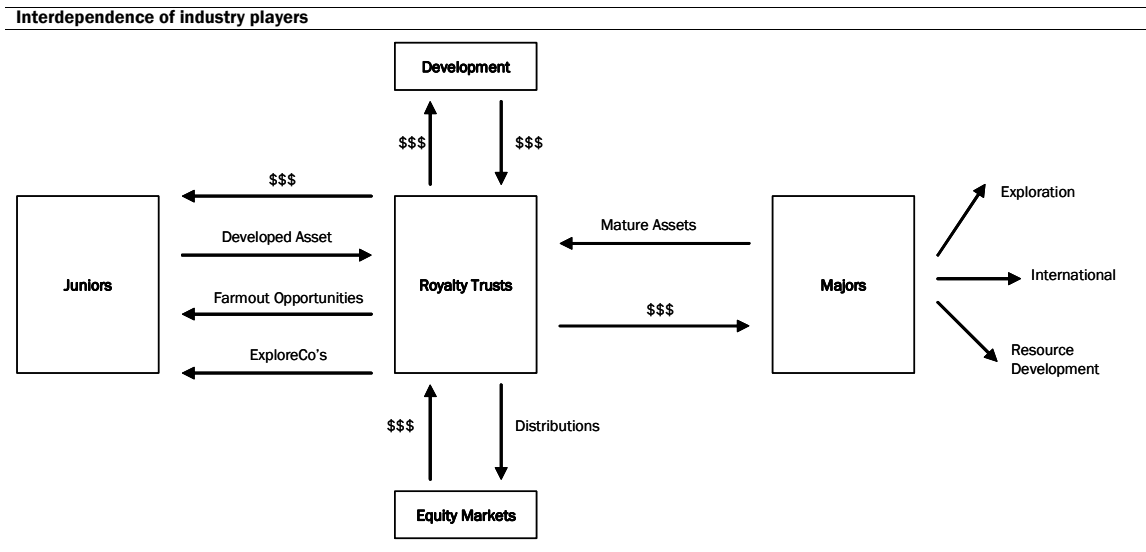
With the increasing maturity of the WCSB, large scale, high impact projects have become the domestic focus of senior producers (multinationals and super independents). These large projects provide the economies of scale and returns required to grow with global demand for scarce technical skills and capital. They also dictate that senior producers must be objective for exponential growth from a small platform.

Small junior exploration companies, which have a different cost structure and higher growth expectations, direct their attention towards discovering new pools that are often too small for the larger companies to profitably pursue. They often invest in higher risk projects in the hope of discovering new reserves.

Bridging the gap between the respective spheres of the senior producers and the junior exploration companies exists a large number of mature Canadian properties. These petroleum producing properties were typically discovered many years ago. While many of these properties still have development opportunities, the economic return and scope of these assets are insufficient to

attract the attention of the senior producers and multinationals which require high impact projects to achieve growth for their shareholders. Similarly, the growth potential is insufficient to attract junior exploration companies. The lower growth potential assets have been accumulated by the trust sector whose investor base values yield not growth.

An important interdependent and symbiotic relationship has developed between the key players in the Canadian energy industry as outlined in the diagram below:



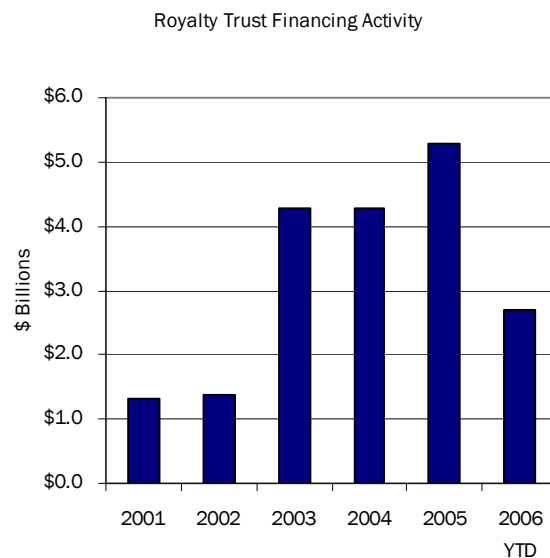
Source: Canaccord Adams

Competition exists across the various subsets of the energy sector but each sub-group has their niches. Since trusts do not tend to engage in high risk exploration, they typically don't compete against the junior or senior sectors for exploration lands. In 2006 trusts acquired less than 5 percent of land sold at Alberta crown land sales. Some competition with senior producers does exist for assets being sold by other senior producers; however senior producers have a financial size advantage when competing for relatively large assets.

## Capital Requirements

The royalty trusts have a very different investor base than conventional oil and gas companies. The trusts' investor base is primarily income-seeking retail investors in Canada and the United States, while the typical investors in E&P companies are large institutional investors. When trusts buy assets, they often finance their acquisitions by raising equity. This effectively provides a new source of capital to senior companies to deploy in large scale, capital intensive projects such as the oil sands; or to junior companies to deploy in exploration.

The trust sector acts as a facilitator to the business plans of both the junior and senior sectors. The trust sector has become, directly and indirectly, the primary source of capital for the capital intensive energy industry. Excluding the \$4 billion of equity raised by Petro-Canada upon their sale to the public, the more than \$17 billion in equity raised by the oil and gas trust sector since 2002 represents more than 50 percent of all energy related financing in Canada during that period, excluding those related to the oil sands. Both the junior and senior sectors have accessed the capital markets primarily via the trust sector through the sale of assets. This is likely due to the lower cost of capital afforded the trust sector through its broad and growing appeal to retail investors, both Canadian and foreign.



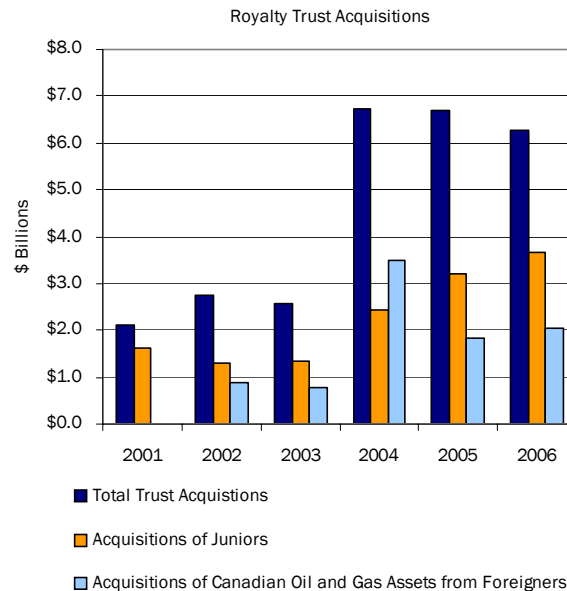
**Source: Canaccord Adams, Company Reports, Financial Post, Sayer Securities**

The senior producers have tended to use the trust sector as a source of capital when selling assets to redeploy in other areas or pay down debt associated with recent acquisitions. As a result, the senior producers seldom issue new equity which is the primary domain of the trust sector.

Many junior producers have used the Trust's access to capital to monetize their businesses and often re-start the cycle with their hands-on technical management and a much smaller production base upon which to build.

## Acquisitions

In a mature basin and with a sustainability approach to development, opportunistic acquisitions are required to replenish development opportunities and / or grow the base production. Trusts have found both the senior producers and junior exploration companies to be the prime source for these assets.



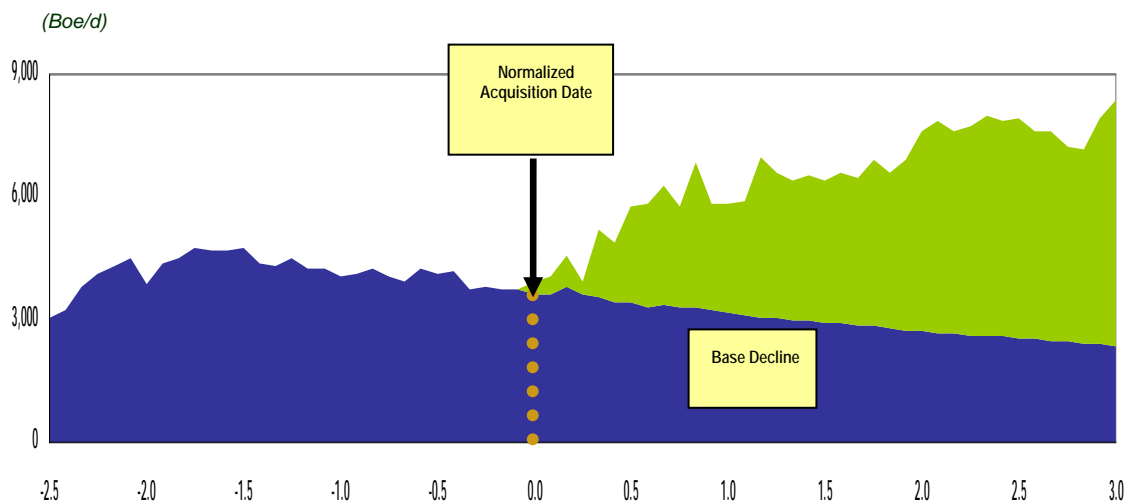
*Source: Canaccord Adams, Company Reports, Financial Post, Sayer Securities*

## Resource Optimization

The larger companies sell the properties that they don't believe merit further investment. The royalty trusts with a low cost of capital find many opportunities to increase production from these assets. There are numerous examples where trusts have undertaken field operations on these assets to a greater extent than the previous operators and improved productivity through reactivations, tie-in of standing wells, drilling of smaller prospects and water flood optimizations.

The following chart groups five of ARC Energy Trust's (ARC") major properties (MIPA, Lindale, Weir Hill, Ante Creek and Prestville), with the acquisition date normalized and represented by "0" years.

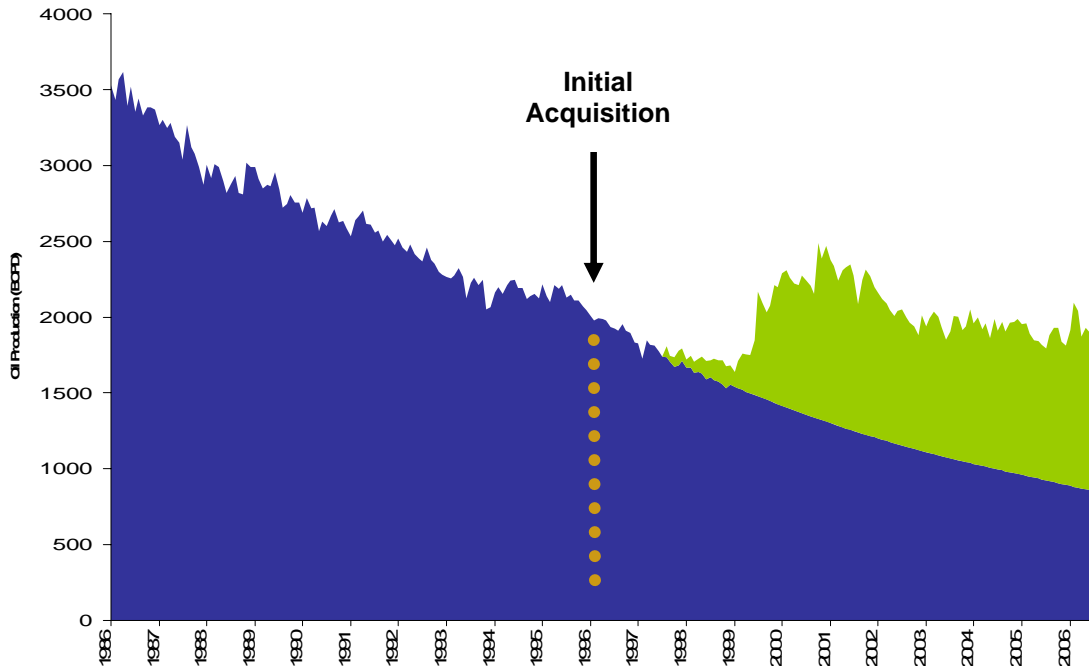
## ARC Major Property Reinvestment



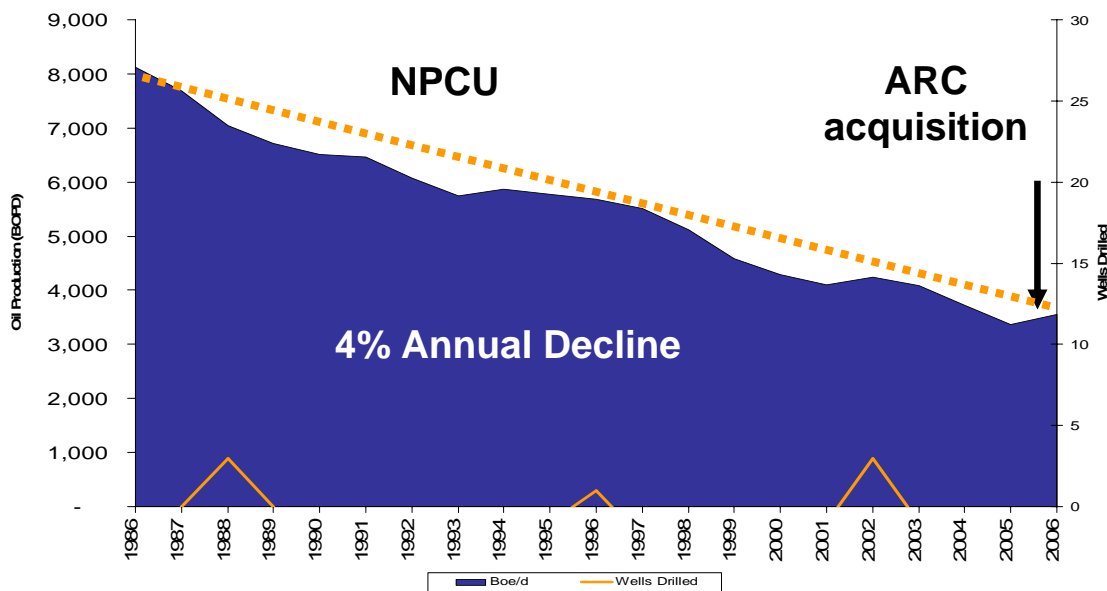
In three years of owning these properties, ARC doubled the production. This is compared to the decline that likely would have been realized by the U.S. corporate owner.

As clearly demonstrated in the figure, ARC was able to take properties which were in steady decline and substantially enhance production. Three years after their acquisition, production was almost six times greater than would likely otherwise have been the case.

In 1996 when ARC was formed, two of the key properties purchased from a major U.S. corporation were the MIPA and Lindale Cardium oil fields in the Pembina area. The U.S. corporation kept an adjacent field, North Pembina Cardium Number 1 ("NPCU"), as they believed NPCU had greater potential than the other two fields. In the ten years that ARC has been operating the "poorer quality" fields, \$44 million (\$22,000 per producing BOE in 1996) has been invested and production has been maintained at the same level as when ARC purchased the fields, so that today, the fields are producing 1,000 BOE/d above where they would have otherwise had they just been left to decline.

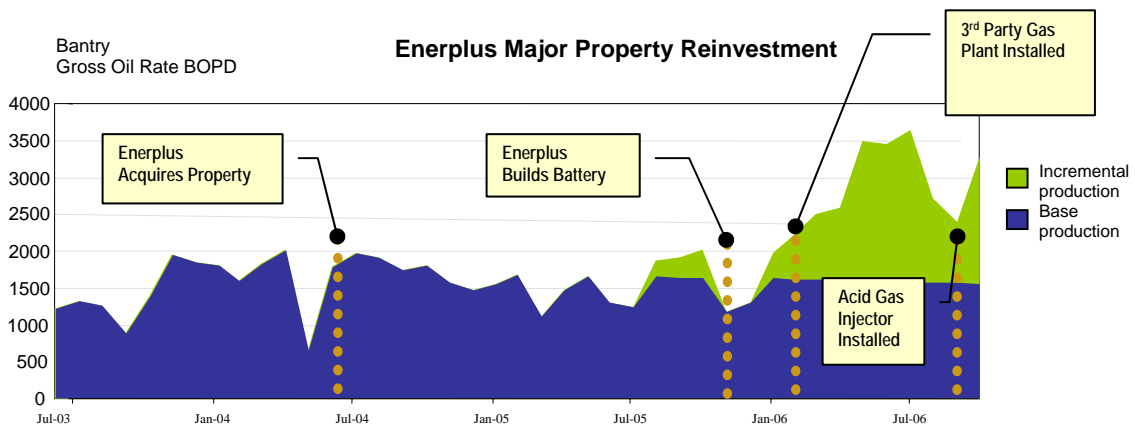


In contrast, the U.S. company has spend \$28 million (\$3,500 per producing BOE) on NPCU and production has steadily declined at an average of four per cent per year over the ten year period. In December 2005, ARC was able to purchase NPCU and has subsequently increased production by five per cent through the re-activation of 65 wells.



This provides a direct comparison between the operating practices of a royalty trust and a U.S. company for two very similar fields both operating in a rising commodity price environment.

Another example is the Bantry North property that was purchased in June 2004 by Enerplus Resources Fund (“Enerplus”) from a major foreign integrated oil and gas company. Since 2000, that company had only drilled seven wells on this property. Enerplus identified a significant investment opportunity and has invested \$33.4 million in drilling 11 wells and construction of facilities since acquisition. This property represented 20 percent of the package of properties Enerplus purchased and the capital investment by Enerplus to-date on Bantry North represents six times the investment the vendor made on all the properties in the year prior to the Enerplus purchase.



These activities added over 2,750 BOE/d of new production. Significant additional investment opportunity exists on the property as evidenced by the 9.8 percent recovery to date of the 51 million barrels of original oil-in-place.

While these examples of activities may individually seem small, when the energy trust activities are aggregated, they sum to a significant increase in production and recoverable reserves.

Some of the development projects the energy trusts are working on will not be economic with the increased cost of capital resulting from the Proposals. The WCSB is one of the most expensive places in the world to find and develop oil and gas because of its high operating costs, low productivity, small scale, and high tax / royalty burden. The energy trusts are helping to ensure that capital and scarce technical resources are not deployed elsewhere in the world.

## Trust Sector Productivity

While some critics have voiced concern that corporate conversions into income trusts “hurt” Canada’s productivity; for the oil and gas royalty trust sector it can be clearly demonstrated that productivity and capital efficiencies are in fact enhanced by the sector. In fact a recent PricewaterhouseCoopers survey on trust productivity (Appendix G) concluded that “trusts have been making an important contribution to the economy investing their capital and growing their businesses at impressive rates” and the “flow-through structure of income trusts creates needed transparency for effective and disciplined capital reinvestment.”

### **Discipline Required to Pay Distributions Leads to Better Capital Investment Decisions**

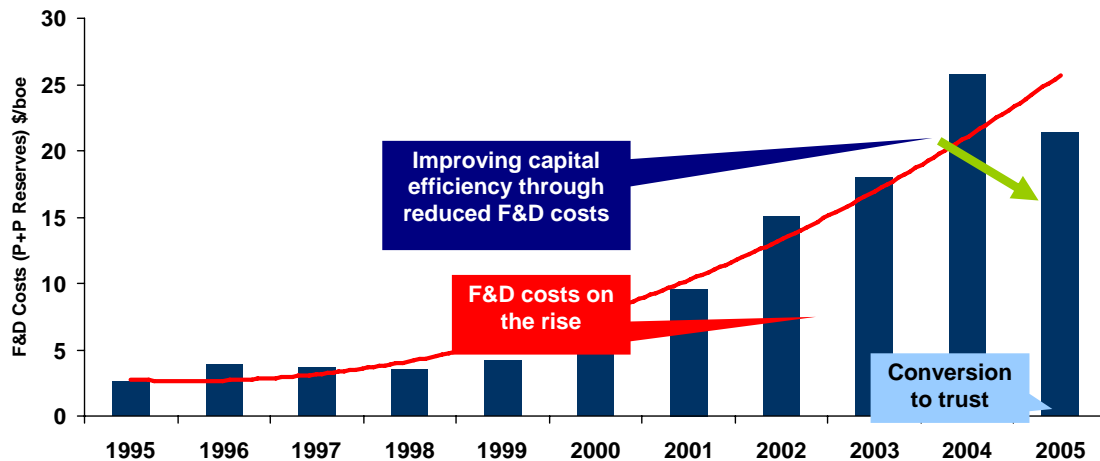
The discipline required to pay distributions has led to better capital investment decisions in the oil and gas industry, especially during times of high cash flow. Quite simply, in a mature basin where production is declining, it is physically impossible for all companies to grow their production. If all companies spend the total sum of their cash flow in the pursuit of growth, many companies will destroy value. In, “Agency Costs of Free Cash Flow, Corporate Finance and Takeovers”, (*American Economic Review*, Vol. 76 (1986) pp 323-339), Michael Jensen, a respected Harvard Business School Professor, argues that when companies have large amounts of free cash flow, their managers can destroy value by wasting cash on corporate empire building, pursuing overpriced acquisitions, or failing to make necessary cutbacks to achieve efficiency. Conversely, he stated that companies paying higher dividends have the potential to add value by forcing fiscal responsibility upon management. Paying out their excess cash mitigates the dilemma created by limited growth opportunities. The Canadian royalty trust sector is living proof of this argument.

One of the best examples of this is Penn West which was a very successful junior E&P company that grew production from less than 5,000 BOE/d in 1993 to 99,500 BOE/d in 2002. Despite spending 95 percent of cash flow for the next 36 months, they were only able to grow production to 105,800 BOE/d. Since converting to a trust, Penn West has paid out 55 percent of its cash flow and still maintained production. Penn West continues to invest significant amounts of capital in development activities, but has improved capital efficiencies through:

- reduction of high risk and high cost drilling;
- the farm out of higher risk opportunities to junior explorers;
- greater utilization of existing infrastructure;
- increased optimization and development of existing assets; and
- efficient budgeting of capital.

Penn West's conversion stimulated improved capital efficiencies, as measured by the cost to bring on a barrel of production. Despite significant service and supply cost increases in the sector, the cost declined from \$36,000 per flowing barrel prior to conversion in the spring of 2005 to \$25,000 per flowing barrel by the end of 2005.

### Penn West F&D Costs



Note: P+P reserves for 2003 onward. Prior to 2003 P+P reserves are P+50%P

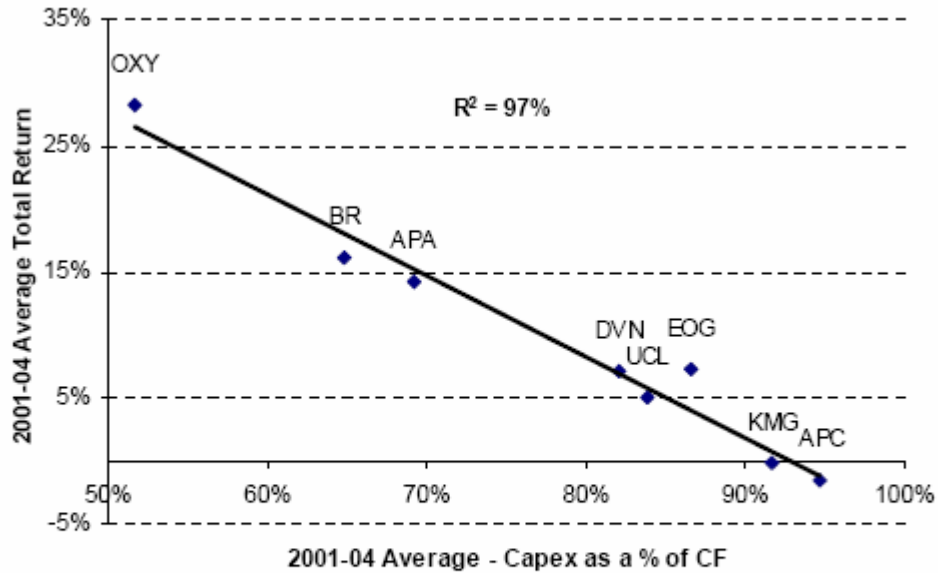
Progress Energy Trust, the result of another conversion of a successful E&P company that had reached a plateau cites its experience in the Deep Basin area to illustrate effective capital utilization:

*“An E&P company would typically approach this multi-zone region by investing large amounts of capital in line- looping and compression to achieve a peak production rate because their investors would be demanding as much growth as possible. Our trust invests capital at a more paced level to avoid over-capitalizing. We continue to drill and add reserves but our pace is suited to filling the existing infrastructure by bringing on new gas production as existing production declines, thereby maintaining a very consistent level of activity and capital investment.”*

Trusts are forced to be more disciplined in their spending of capital, as they return a significant portion of their cash flow to their investors. Instead of spending capital on high risk exploration programs or over-accelerating production, trusts create value by spending on optimization, exploitation and development. The destruction of shareholder value by overcapitalization and poor risk management is not unique to western Canada. Tom Driscoll, senior

oil analyst at Lehman Brothers in the United States has observed the same phenomenon in his examination of large cap American oil and gas companies. Over the period of 2001 – 2004 Driscoll found a strong inverse correlation between total stock market return and percentage of cash flow spent on drilling activities, that is, the more spent, the lower the total return.

2001-2004 Drilling Capex as a percent of Cash Flow versus Total Stock Return for Large Cap Stocks



Note: Capex used is Drilling Capex which includes acquisition of undeveloped leasehold but excludes capex for acquisition of producing properties. Capex and cash flow for KMG, OXY, and UCL exclude the capex allocated to the chemicals business as well as the estimated cash flow contribution from the chemicals business.

Source: Company reports and Lehman Brothers estimates

## **Cost of Capital**

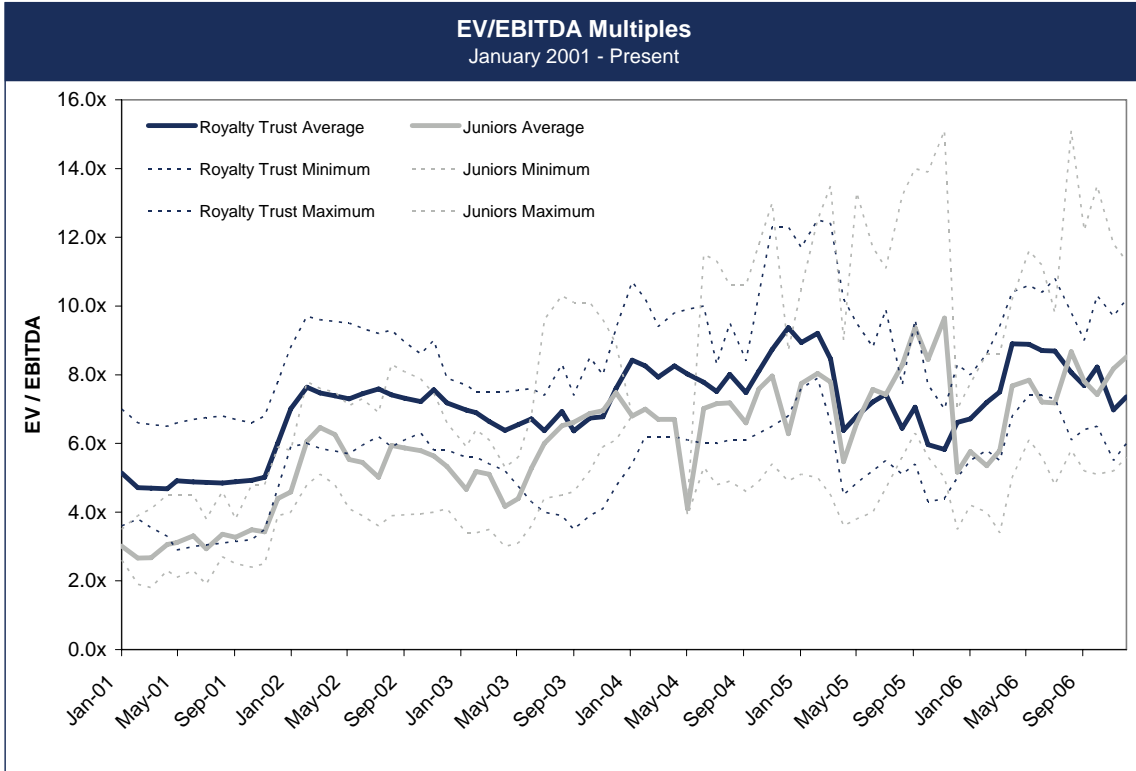
“Cost of capital” is a finance term that refers to what it “costs” a company to raise capital, normally either debt or equity, so as to finance its development activities. The cost of debt is generally the interest rate the company pays to maintain it. The cost of equity is essentially the expected rate of return demanded by investors to buy or hold a share or unit. Generally, the riskier an equity investment is, the higher the rate of return investors will demand to hold it.

Cost of equity capital can be measured by evaluating a company’s share price in relation to metrics that describe a company’s potential profitability such as enterprise value to EBITDA, enterprise value to debt-adjusted cash flow, enterprise value to net asset value, enterprise value to booked reserves, enterprise value to daily production and enterprise value to cash yield for example. The analysis can be complex as there is no one metric that can truly describe a company’s cost of capital. A lower cost of equity capital really means a higher share price relative to the suite of evaluation metrics for one company as compared to another and is created by higher demand.

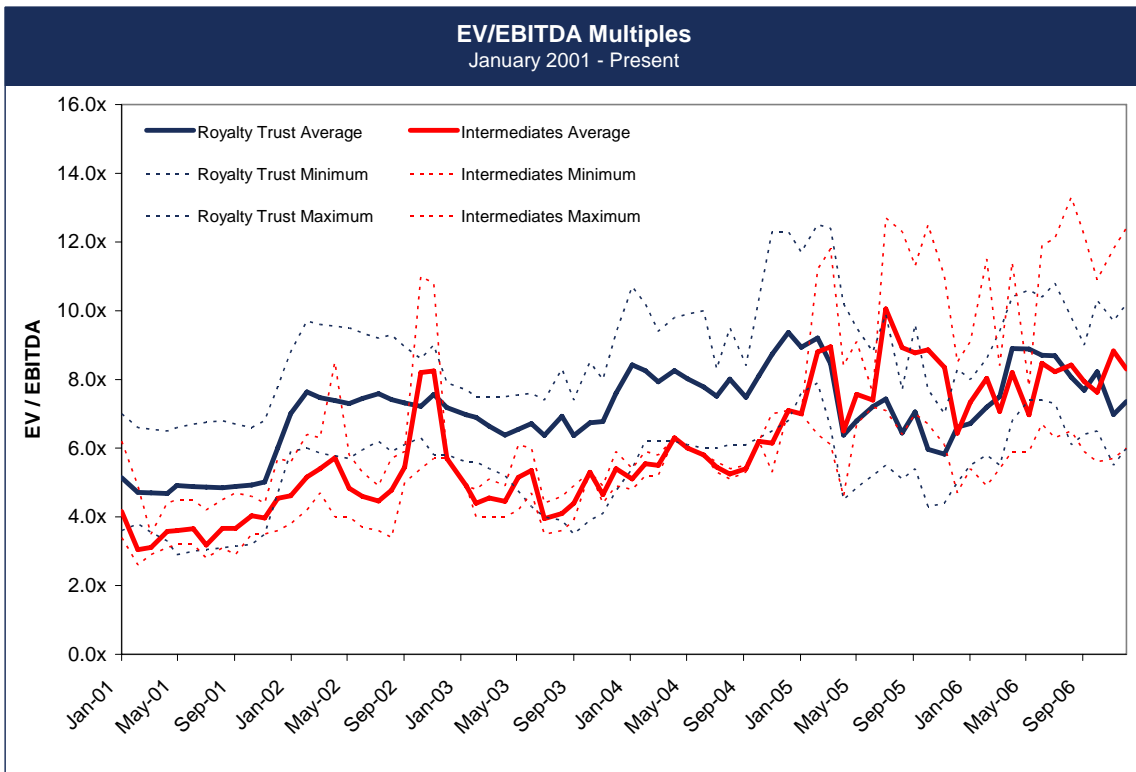
### **Cost of Capital Comparison to Other Sectors**

Although the cost of borrowing, debt capital, for royalty trusts is generally comparable to conventional E&P companies of similar size, the cost of equity capital to royalty trusts has historically been lower, prior to the October 31, 2006 Federal Government tax proposals. It should be noted that both entities are in essence oil and gas companies and operate under the same regulatory environment but they attract a different investor base.

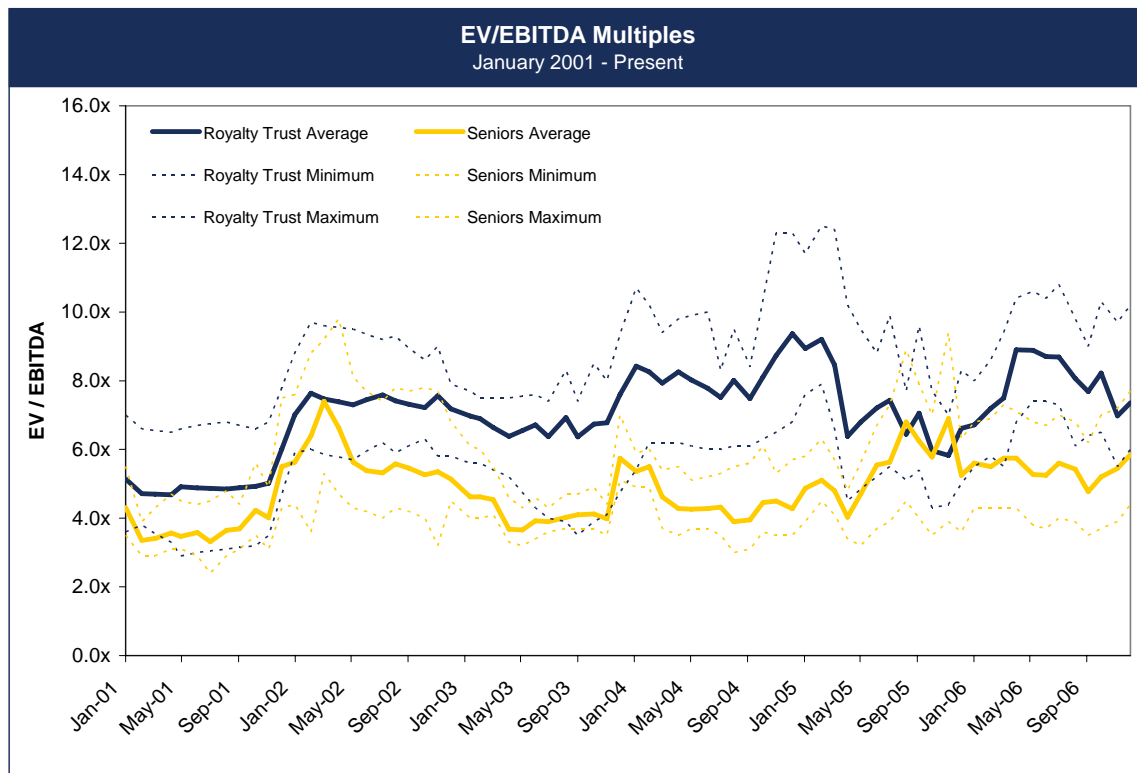
The following three charts depict enterprise value as a ratio to EBITDA over the past almost seven years since January 2001 for royalty trusts as compared to Juniors, Intermediates and Seniors. It can be seen that prior to early 2005, royalty trusts were valued higher on a relative basis than all three sub-groups. In early 2005 this changed and relative valuations for Junior and Intermediates surpassed those for the trust sector on average. Of further note, there is a wide range of valuations within each of the sectors themselves as the market differentiates on the basis of a myriad of factors including asset quality, management track record, investment opportunities, ability to execute activity, cost control, netbacks etc. That market differentiation as it translates into multiple spreads has historically been most extreme within the Junior sector and tightest amongst the Seniors as by nature the asset bases of the Seniors are typically diversified and individual unique opportunities are less able to impact ultimate valuations.



Source: BMO Capital Markets



Source: BMO Capital Markets



Source: BMO Capital Markets

Energy trust investors generally accept lower returns than corporate investors because:

- Trusts focus on more predictable, lower risk development;
- Trusts generally re-invest a smaller portion of their cash flow in the business to sustain production and distribute a higher portion of this cash flow to investors and in this world of low interest rates, investors value this yield;
- Distributed income is a concrete return which cannot be eroded by other market risks;
- The ability to “flow-through” tax responsibility to investors puts the maximum income into investors hands increasing the opportunity for re-investment or spending in the economy prior to taxation;
- Distributions can be reinvested by Canadians at their pre-tax value, allowing compounding of investment prior to taxation;
- The trust model offers more discipline and transparency. When trusts make major acquisitions, they typically raise additional equity, offering investors the option of participating with the full knowledge of the acquisition metrics and rationale. In comparison, corporations are able to fund acquisitions and major projects internally, without the discipline of asking investors for approval and financing; and
- Trusts give investors maximum flexibility in custom building their risk profile and diversifying their portfolio. The trust’s management makes investment

decisions which sustain the business while the investor makes the decision on the reinvestment of excess cash flow either back into the trust for future decisions by the trust's management or elsewhere in the energy industry or otherwise through capital markets.

The royalty trust concept appeals to a segment of the capital markets interested in a relatively low risk income stream from their investments. This market segment is broad based and growing, particularly with an aging population focused on supporting current living expenses in an environment of low interest rates. In addition, the market has reacted to investment losses in conventional growth-oriented corporations both within and outside the energy sector as witnessed in the dot-com market correction. The returns on capital invested into conventional Canadian oil and natural gas activities is expected to continually decrease as the WCSB continues to mature. Instead of investing exclusively in growth stocks, some investors are also investing in entities in mature industries where a more disciplined approach to reinvestment provides reasonable "risk-adjusted" returns. Rather than companies reinvesting cash flow into higher risk activities, these investors prefer that this cash be distributed back to them so they can reallocate the after-tax amounts into other sectors of the market.

## **Low Cost of Capital Required to Improve Ultimate Recovery**

Over the past twenty years, energy trusts have made a successful business out of purchasing assets from large companies, making investments in those properties that the previous owners did not deem worthwhile and increasing production and reserves. Energy trusts have been able to accomplish this feat because they have had, at times, a low cost of capital.

This low cost of capital means that trusts can invest more money in projects that would provide only marginal returns for organizations with a higher cost of capital. Trusts, as a sector typically have a lower hurdle rate of return for investing or deploying capital. In a mature basin, this is a very significant factor in helping to extract the last economic drop of oil and gas. This low cost of capital allows royalty trusts to in turn keep Canada's oil industry vibrant by prolonging the economic life of mature oil and natural gas properties that would otherwise remain under-exploited.

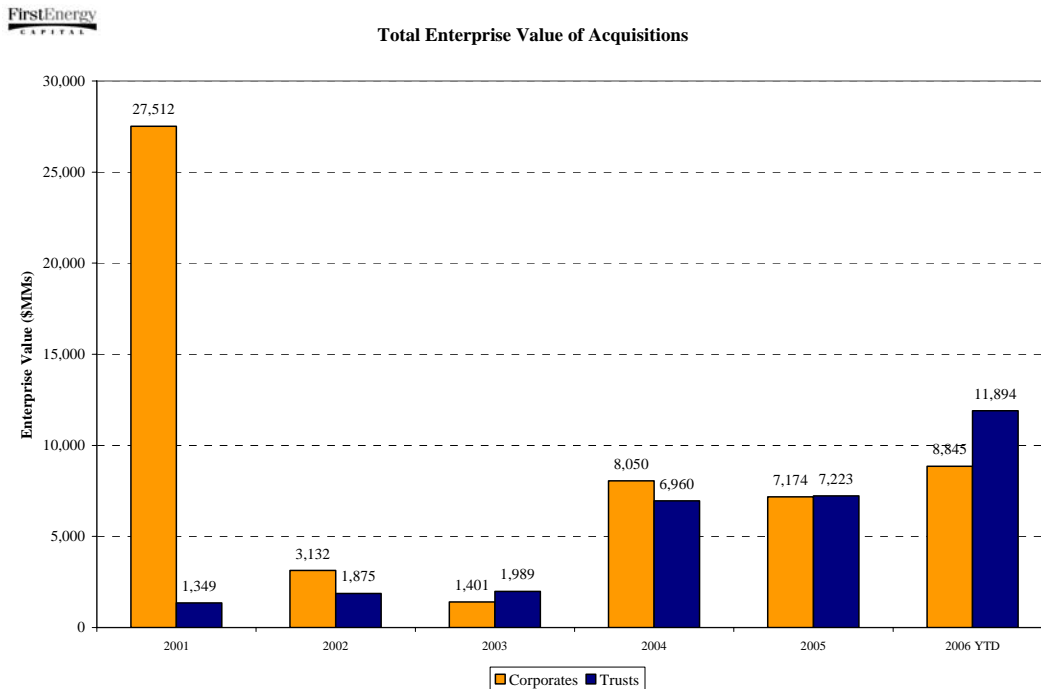
Large E&P companies share our cost of capital through the sale of large amounts of assets to the energy trusts. This is because the trust's cost of capital is a strong determinant in what can be paid for such assets. Similarly, junior companies access the trust sector's low cost of capital when they convert to a trust or sell their assets to a trust.

## Low Cost of Capital Has Not Translated Into Unfair Competitive Advantage

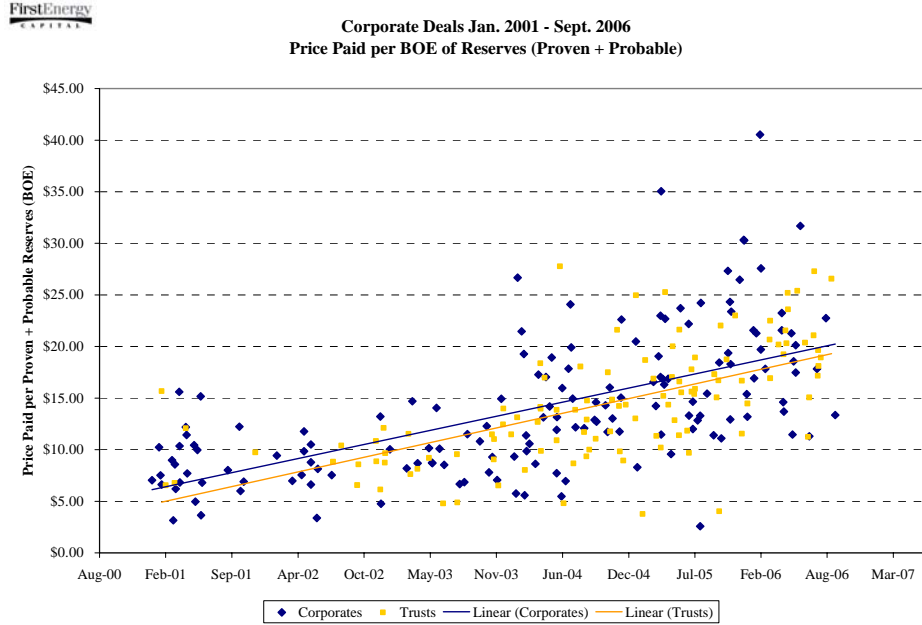
The government expressed concern that tax structure has driven an unfair cost of capital disparity within the energy sector. Therefore, it is important to understand if the Trust's cost of capital advantage has translated into an unfair advantage in the way trusts and corporations interact in the WCSB. A cost of capital "advantage" would be important where trusts and corporations are competing and the acquisition market is a highly visible way to evaluate this.

To suggest that oil and gas trusts have a cost of capital "advantage" over large exploration and production corporations that is giving trusts an unfair advantage in the WCSB is difficult to accept given that much larger corporations have numerous economies of scale advantages which offset cost of capital issues and juniors have more recently experienced lower costs of capital than any sector of industry. But if this allegation were indeed true, that would suggest that corporations would not be able to compete with trusts in the acquisition market. That is simply not the case.

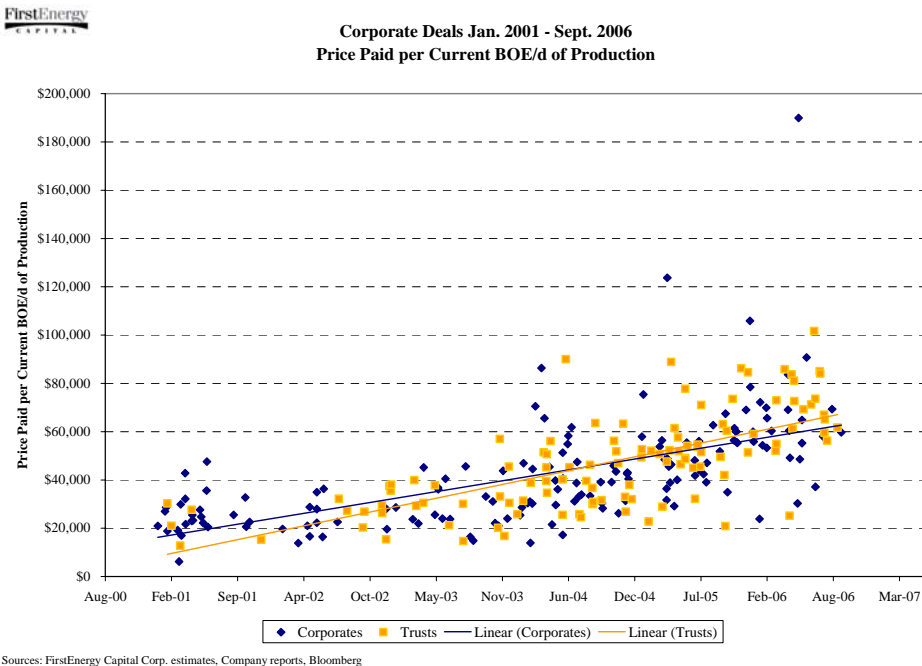
From the graph below, we can see that corporations have not been squeezed out of the acquisition market by trusts but rather trusts and corporations have been equally active in making acquisitions over the past five years. The graph below excludes data for the recent \$4.5 billion acquisition of Anadarko Canada by Canadian Natural Resources as this transaction just closed in early November 2006.



The data for the past five years does not suggest that trusts are pricing corporations out of the acquisition market. In fact, on average royalty trusts have paid slightly less than corporations for oil and gas reserves, as indicated in the scatter plots below.



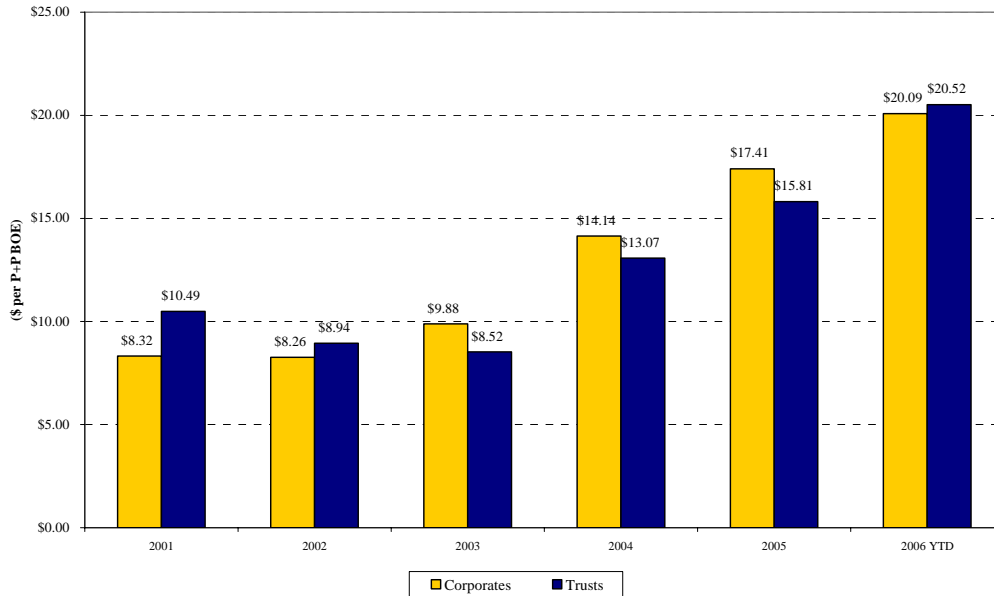
It does appear that trusts more recently have been willing to pay slightly more on a flowing barrel of oil basis than corporations, illustrating trust's affinity for cash flow as part of the trust model.



The significant variability in transaction metrics relate to many transaction specific factors including, but not limited to characteristics of the base assets, technical risks, upside potential, commodity prices, synergy and deal accretion with the purchaser.



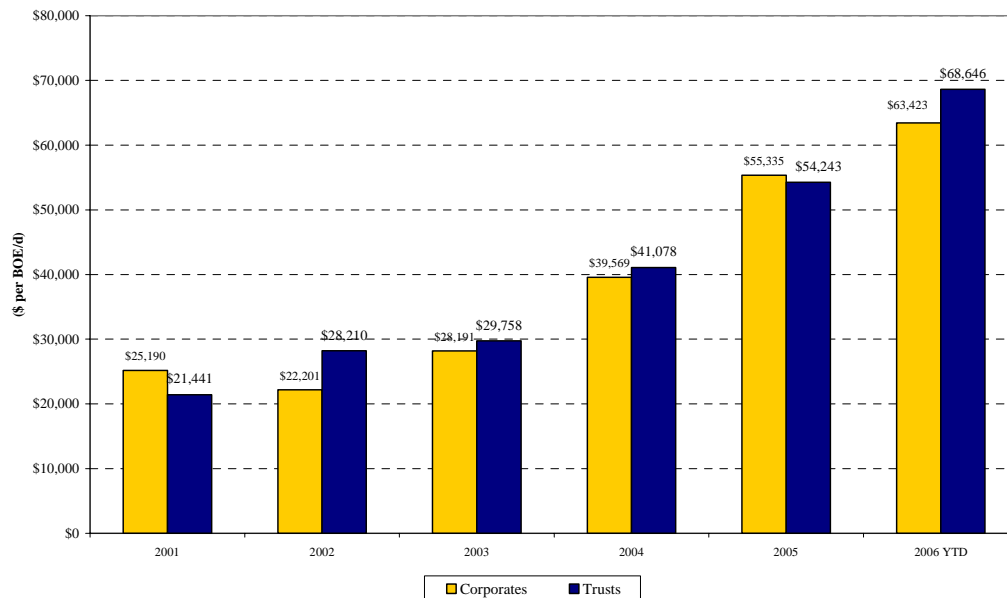
Average Price Paid per BOE of Reserves (Proven + Probable)



Sources: FirstEnergy Capital Corp. estimates, Company reports, Bloomberg



Average Price Paid per Current BOE/d of Production



Sources: FirstEnergy Capital Corp. estimates, Company reports, Bloomberg

# Tax Considerations

## Background Information Regarding Energy Sector Taxation

The current taxation system is designed to motivate appropriate spending on different types of assets. The Department of Finance outlined this eloquently in its technical paper titled “Improving the Income Taxation of the Resource Sector in Canada”, written in conjunction with Budget 2003. Exploration is motivated by Canadian Exploration Expense deductions and flow-through shares. Spending on non-conventional mining projects is motivated by accelerated capital cost allowance recovery. Resource spending in Atlantic Canada is motivated by the Atlantic investment tax credit. All of these measures are in place to promote the goal of maximizing recovery of Canada’s finite oil and gas resources.

One of the best places to find oil and gas is where oil and gas has already been found. Generally speaking only a fraction of the hydrocarbons actually in place in a reservoir is recoverable through conventional low cost production techniques. Driven by economic parameters, a myriad of other opportunities exist to improve recovery from discovered oil and gas fields. Examples include increased drilling density, field facilities optimization, special downhole equipment and surface facility installations, waterflood or enhanced oil recovery schemes.

Increasing recovery of oil and gas from previously discovered fields is a worthy pursuit. Under conventional primary recovery techniques, typical recoveries range from 5 to 50 percent for oil, averaging closer to 20 percent. This means that anywhere from 50 to 95 percent of the original oil in place is typically left in the ground. The return on investment gets exponentially lower as more and more capital is required to extract increasing amounts of the oil and gas in place in any given pool. Generally speaking these are the lower risk but also lower return projects in the oil and gas sector in Canada.

While there are limited special incentives to focus on extracting the maximum amount of oil and gas from a discovered asset, the trust structure has allowed for increased recovery of mature assets within Canada as investors are aligned with the risk / reward profile of this mature type of asset base. This is driven by the attractiveness of the structure of the business to investors thereby providing a low cost of capital or reducing the hurdle rate required for reinvestment. Further, this translates into more projects that meet the business’ economic hurdle rates and ultimately higher recovery of oil and gas. Extinguishing the trust structure will most certainly lead to significantly less oil and gas recovery from Canada’s resource base.

## Taxation Process for Trust Income

Energy trusts currently flow their taxability through to their unitholders as distributions are paid. The tax analysis in Appendix H present a theoretical model of taxes paid by investor type under the current tax system (Old System) and under the Proposals (New System) for investors in:

- 1) an energy trust which distributes 100 percent of its cash flow (“100% Payout Trust”); and
- 2) an Alberta-based corporation which pays out all of its after-tax cash flow as dividends to shareholders (“Distributing Corporation”).

This information highlights the following with respect to the Proposals:

- The theoretical model illustrates how one could conclude that there is little relative tax difference between the corporate and trust structures under the Proposals; and
- The punitive effect on Canadian retired seniors due to double taxation in both the existing corporate system and the new trust system under the Proposals is evident; a 63 percent tax rate in the case of the 100 percent payout trust. Furthermore, this would be significantly worse in the case of the New System as compared to the Distributing Corporation if one were to incorporate the compounding effect of reinvestment within registered entities as outlined in pages 9 through 11 of Appendix C.

Setting the theoretical situation aside, Appendix H then illustrates how the energy sector actually works in practice and how tax revenues are actually enhanced by the current trust taxation structure. Three additional cases are presented:

- 1) an energy trust which reinvests 40 percent of its cash flow in development expenditures and distributes the remainder (“Sustainable Trust”);
- 2) an energy corporation which reinvests all of its cash flow in development and pays no dividends (“Growth Corporation – 100% Development”); and
- 3) an energy corporation which reinvests all of its cash flow in exploration expenditures and pays no dividends (“Growth Corporation – 100% Exploration”).

These assumptions are much more reflective of the current state of the oil and gas industry with 60 percent being an average trust payout ratio and corporations paying very low levels of dividends.

Under the Old System, all investors in trusts focused on sustainability pay tax at a much higher percentage of taxable income (9% for foreign investors to 28% for tax-deferred Canadian investors) than investors in growth-oriented

exploration corporations (0%). Further, all Canadian trust investors pay tax at a higher effective rate than investors in corporations investing purely in development activities. Under the New System, the percentage of taxable income paid by trust investors increases dramatically even relative to corporations reinvesting in development activities.

The above analysis does not consider the additional complicating factors of production growth/decline from differing relative levels of capital investment, timing differences from the related tax pool additions and present value effects. Appendix I presents a simplified depiction of many of these factors. While not necessarily rigorous, it highlights the massive complexity of this system. Also missing from this analysis is the capital gains tax that might be paid by investors in future as a result of the reinvestment activities of the corporation or trust. Foreign investors pay no capital gains tax to the Canadian government.

It is clear that the lowest ultimate total tax burden results when a corporation reinvests all of its cash flow and pays no dividends. This reinvestment may or may not be efficient. However, the Proposals will incent trusts to reinvest more of their cash flow generally lowering capital efficiencies. This reinvestment may be a poor business decision in the case where investment is not prudent, namely assets where cash flow far exceeds the productive uses for it such as mature oil and gas assets, pipelines and energy infrastructure, ultimately leading to reduced capital efficiencies. In those cases where the incentive to retain cash prevails, excess cash flow will either be used non-productively in share buybacks for example or sub-optimally for purposes such as diversification or overcapitalization.

Not only does this analysis call into question any assumption of reduced tax revenues as a result of the energy trust sector but it also suggests that the arguments for leveling the playing field are not valid. The Proposals will effectively create a single world where entities are encouraged to retain cash flow by the tax system, notwithstanding the desire for income by investors and the optimal investment profile for a particular asset base. Through the Proposals, the government is effectively deciding how businesses should do business.

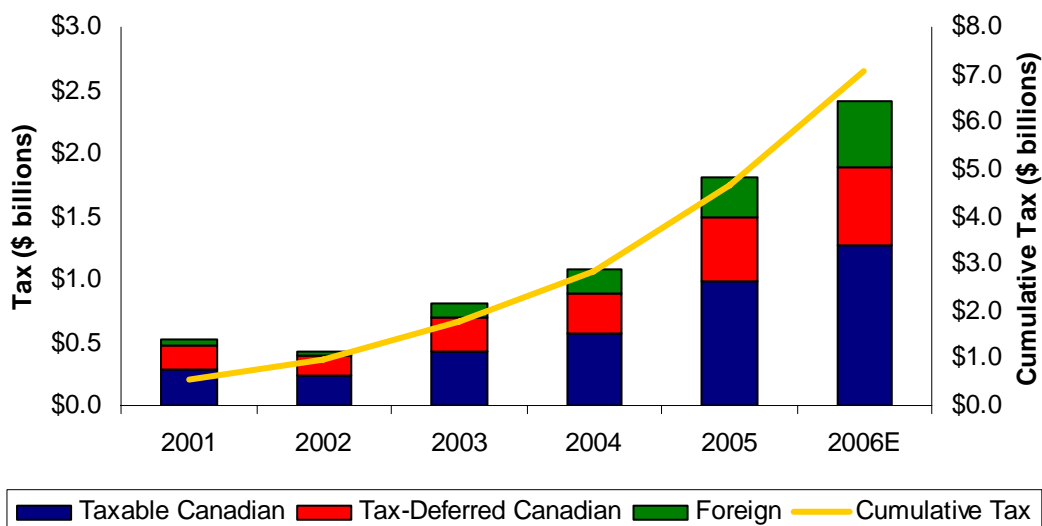
## **Federal Tax Generated Directly by Trust Distributions**

In 2006, an estimated \$8.0 billion will be distributed to unitholders from the energy trust sector. It is estimated that these distributions will generate approximately \$2.4 billion in tax revenue for the Canadian federal and provincial governments in 2006, \$1.8 billion of which is estimated will be collected currently, as follows:

2006E	Average Ownership <sup>(1)</sup> (%)	Average Tax Rate (%)	(\$millions)
<b>Distributions by energy trusts</b>			\$ 8,000
<b>Income and Withholding Taxes</b>			
Taxable Canadian Unitholders <sup>(3)</sup>	40%	46%	1,267
Tax-Deferred Canadian Unitholders <sup>(5)</sup>	17%	46% <sup>(2)</sup>	628
Foreign Unitholders <sup>(4)</sup>	43%	15%	517
<b>Total Tax</b>			<b>\$ 2,412</b>

- 1) Based on weighted average of CCET member estimates
- 2) Tax on deferred accounts will be collected upon withdrawal from tax-deferred accounts
- 3) Assuming 86 percent taxability of distributions to Canadian unitholders based on average energy trust sector data
- 4) Assumes all foreign ownership is the equivalent of U.S. ownership with 15 percent withholding tax. Actual withholding tax is 25 percent; reduced to 15 percent by tax treaties with certain countries including the U.S.
- 5) While tax on deferred accounts will be collected in the future, the present value of future tax revenues is assumed to at least equal current revenue foregone when considering growth in deferred accounts. (See pages 9-11 of Appendix C).

Distribution-related taxes have increased substantially over the past five years:



Source: CCET member data

The Government of Canada recently announced significant budget surpluses and an unexpected increase in personal tax revenues. Personal tax revenues have grown faster than the rate of wage inflation and the GDP rate. The portion of the unexpected increase attributable to the trust sector has not been identified or recognized by the government but it is likely that income trust distributions have been a significant factor in this increase.

## Discussion of Government Concerns With Respect to the Tax Treatment of Trusts

**Government Assertion:** *Canadian tax-exempt investors, such as Canadian pension funds and RRSP investors, and non-resident investors, benefit inappropriately from investing in an FTE rather than a corporation.*

**CCET Response:** Canadian Pension Plans and RRSPs are tax-deferred, not tax exempt. Furthermore, Canadian tax-deferred investors benefit appropriately from investing in flow through entities.

**Non-resident investors are critical to the efficient development of Canada's energy resources. Foreign investors will be subject to taxation in their home jurisdiction and don't benefit significantly from what Canadian tax dollars pay for. This must be taken into account when developing tax policy if Canada is to be competitive in attracting foreign investment dollars.**

### *Tax-Deferred Investors*

The Proposals characterize investments such as RRSPs and pension plans as "tax-exempt". Such investments are not really tax-exempt but rather tax-deferred and when withdrawals from these vehicles are made they are taxed as ordinary income at the highest marginal rate for the individual investor. Under the Proposals, an RRSP holder in Ontario could face total tax of 63.3 percent on one dollar of energy trust distribution (31.5 percent tax on distribution and 46.4 percent tax on the remaining \$0.685 on withdrawal from the plan). **This can be a punitive result even after the deduction for initial contribution to the Plan is taken into account.** Taxation of distributions before the funds are received by an RRSP and taxation at full marginal rates upon withdrawal will truly represent a double taxation issue, after the initial contribution deduction is recovered.

It has been a long standing principle of income tax law of neutrality that various sources of income ultimately should incur the same amount of tax. The main purpose of the dividend tax credit is to give credit to individual taxpayers for the income tax paid on their behalf by corporate entities. This principle has been thwarted with respect to tax-deferred investors under the current tax regime, as the tax paid by the corporations owned by tax-deferred investors is never returned to them. The Proposals perpetuate this element of double taxation within the trust sector which is ultimately borne on the backs of individuals saving for their retirement.

In Gord Tait's dissertation in Appendix C, in the section titled "Trusts and Tax-Deferred Accounts" on pages 8 through 13, it is argued that trust distributions in

tax-deferred accounts contribute to a huge bank of savings for the government and serve to actually increase government tax revenues overall. There are two principal reasons for this:

- There is no time value cost, or loss (in fact there likely is a gain), to government revenues when trust units or other securities are held inside tax-deferred accounts; and
- The tax cost of the contributions in any given year is offset by taxes collected on the withdrawals in any given year.

Tax fairness might be better achieved if the treatment of dividends from corporations were grossed up and credited and taxed at withdrawal mimicking the treatment of distributions prior to the October 31<sup>st</sup> Proposals. This would certainly further equalize the treatment of corporate dividends and trust distributions and allow both the government and Canadian investors to further benefit from the positive income and tax revenue increases that result within tax-deferred plans.

It is our understanding under the Income Tax Act, pension funds and other such tax-deferred organizations can hold a direct interest in energy assets without incurring any federal or provincial taxes on annual income. Consequently, as a result of the taxes on FTEs under the Proposals, pension funds will likely dispose of their energy trust investments in favour of direct investments to obtain the same amount of annual cash flow from energy without additional tax revenue. However this “segregation” of investors and assets increases administration and therefore reduces productivity overall for the energy industry as lawyers, accountants and associated personnel will be spending time and resources on “splitting the pie” rather than focusing on “how to increase Canada’s oil and gas reserves and associated production”. In addition this segregation is detrimental to the Canadian retail investor as pension funds and other such large institutional investors are much more attuned to evolving business practices and are vocal on governance practices which benefit retail investors. This “governance role” of pension funds and institutional investors is significantly diminished if their investment is in a different form than retail investors which is a plausible outcome of the Proposals.

### *Non-Resident Investors*

Foreign investment in the Canadian oil and gas industry has always been significant and critical to the sector’s continued expansion. Canada’s resource sector has always relied on foreign capital to fill the gap between industry needs and the size of the Canadian economy/investor base. Fourteen of the largest 25 Canadian oil and gas producing corporations are subsidiaries of foreign corporations, representing 22 percent of Canadian oil and gas production. None of these entities paid dividends in Canada, none of the capital gains on the sale of parent-entity’s stock by foreigners would be subject to Canadian withholding tax and repatriation of funds from Canada is generally

accomplished through structures which attract little or no Canadian withholding tax. In fact, no capital gains tax is paid in Canada by foreign investors as their gains in Canadian stocks are taxed in other jurisdictions.

Is the government concerned about the extreme scenario whereby U.S. investors being the marginal buyer drive Canadians holding trust units in taxable Canadian accounts out of the unitholder base for trusts? Concerns have been raised regarding:

- The absolute Canadian tax revenues generated in the extreme conversion of corporations to trusts and the trend to high foreign ownership;
- 15 percent being a lower rate of tax than that for a Canadian taxable investor; and
- Foreign control of the Canadian energy industry.

Taken to the extreme, if 90 percent of the Canadian energy trust industry was owned by U.S. investors, the 15 percent withholding tax would have still generated \$1.1 billion in withholding tax on 2006 estimated total distributions of \$8.0 billion versus the \$1.9 billion of current tax revenues anticipated from taxation of energy trust distributions in the hands of its current unitholder base.

Trust distributions to non-residents currently attract a 25 percent Canadian withholding tax reduced to 15 percent by treaty for Unitholders in many jurisdictions including the U.S. In comparison, the Canadian withholding tax on interest payments to non-resident debt holders is 10 percent unless the debt has a term greater than 5 years, in which case the withholding tax is zero. For foreign holders of common shares (less than 25 percent in public corporations) there are no Canadian tax revenues generated for capital gains. In a world of “stable” economic parameters, the trust structure provides investors with distributions in lieu of capital gains. Again Gord Tait’s paper in Appendix C, pages 14 through 16 in the sections titled “Trusts and Non-Resident (Foreign) Investors” and “The Junk Bond Economy” discusses the disparity in the tax treatment of foreign investors in the three principal ways that foreign investors can participate in Canadian investments, besides trusts; those being corporate bonds or other debt instruments, common shares and direct investment.

It should be highlighted that the withholding tax from foreign investors comes to Canada as a result of their infusion of much needed capital into our industry without any commensurate burden being placed on our social services, health care systems, education systems or infrastructure. With this in mind and the fact that they will be taxed in their own countries for such services, the question really is; What is the tax rate that can be applied to foreign investors while still attracting their investment capital? For capital gains it would appear to be zero, for interest somewhere between zero and ten percent.

Trusts are effectively the high yield investment vehicle in Canada with a unique risk / reward profile. They are a hybrid investment providing the return of high

yield debt instruments but with exposure to risks that are similar to those of common share equity in corporations.

The government has stated that they believe that 15 percent withholding tax alone makes this “expensive capital” for Canadians from a tax revenue perspective. CCET believes that the 41.5 percent tax rate in the Proposals will completely drive away foreign ownership in energy trusts. What is the compromise to meet the objectives of all the stakeholders?

Since trusts are a hybrid of all three of the investment types that are currently available to foreigners, theoretically some tax rate within the spectrum of tax treatments from zero on long term debt and capital gains, to the effective tax rate on corporations; to a maximum theoretical 31.5 percent is fair, in terms of total taxation, including withholding tax. The current 15 percent withholding tax seems to be an appropriate middle ground. We know that rate is adequate to encourage foreign ownership in energy trusts but the government has expressed concern that this rate may be too low to control the magnitude of this “expensive” capital.

There is an optimum tax rate for foreigners on trust income related to the balance between:

- Meeting the concerns of government and their objective to limit the ultimate cost of this capital from a tax revenue perspective;
- Establishing fairness to all stakeholders, including corporations, foreign investors, high yield debt issuers, trusts and their investors; and
- Attracting the appropriate amount of foreign capital to benefit Canadians particularly in specific industries, such as energy which is strategic and critical to Canada and the global economy.

The government’s objective to curb the ultimate desire of foreigners to own trusts to guard against the extreme scenario of very high foreign ownership and ultimately reduced tax revenues from the activities of businesses in Canada may not be warranted in certain industries such as Canada’s energy industry. But if it is, this can be accomplished through means that are significantly less punitive than the October 31<sup>st</sup> Proposals.

Rather than transferring control out of Canada, the energy trust sector has seen its foreign ownership rise to over 40 percent and yet the head office, management and control of every single energy trust has remained in Canada. In contrast only 8 of the 25 largest oil and gas producing corporations in Canada have their worldwide headquarters in this country.

The Proposals will, if implemented, create a cost of capital advantage for Canadian subsidiaries of U.S. foreign energy companies relative to Canadian energy trusts. Such subsidiaries are permitted to finance operations with high levels of leverage effectively shifting taxable income out of Canada at the cost

of only a withholding tax on interest to a maximum of 10 percent. This will be significantly less than the 41.5 percent tax borne by U.S. investors in energy trusts if the Proposals are implemented and could give foreign-controlled entities a competitive advantage in the WCSB.

**Government Assertion:** *The unbalanced tax treatment of trusts creates an economic distortion through the proliferation of income trusts that is threatening Canada's economic growth and competitiveness.*

**CCET Response:** **The trust structure is the appropriate business structure for the type of oil and gas assets owned by energy trusts in order to maximize the efficient development of Canada's strategic energy resources while generating significant cash flow to both governments and investors.**

The present Canadian tax system provides a substantial incentive for a corporation to retain its cash. The current rate of tax on income retained by a corporation in Alberta is about 32 percent while the rate on "distributed cash" (corporate tax and tax on dividends) is about 46 percent. The Proposals argue that a structure which defeats the tax incentive to retain earnings, such as the current trust structure, hurts reinvestment, and hence productivity. However, incentives in the tax system to retain cash flow and reinvest do not invariably cause corporations to make good use of these retained monies. The spending of capital does not create productivity. Spending capital wisely does.

Corporate management is not necessarily better at reinvesting cash flow than individual investors. Depending on the asset base and management expertise of a particular corporation, the myriad of opportunities to invest in outside a given corporation may be significantly more attractive than within the corporation. In essence, the premise behind income trusts is that the market can be more efficient at allocating excess capital than a manager in one particular business or industry. This redistribution of excess capital, among other things, enhances productivity and economic efficiency.

Industry may spend wisely, where businesses or industries are growing profitably and require large infusions of capital. However, where businesses are mature as many in the WCSB are, this incentive often causes corporations to use surplus funds to diversify, purchase unrelated assets, to undertake sub-optimal investment or to repurchase their own stock. None of these activities likely adds to productivity. Good corporate governance would dictate that the excess cash generated from operations in mature industries be returned to shareholders in order to allow for the efficient re-investment of those funds by investors.

The business premise behind the energy trust structure is that the types of assets owned by the trusts generate cash flow substantially in excess of the

amount of reinvestment required for efficient ongoing development. The energy trusts have been successful in creating value by adhering to this investment discipline. The remaining cash flow is distributed to an investor base that prioritizes income, for living expenses and general spending in the economy and/or for reinvestment in capital markets. Thus a balance has been achieved between efficient development of energy assets, the economic needs of an aging North American society and reinvestment in the economy and capital markets.

**Government Assertion:** *Tax revenues are reduced as a result of the growth of the income trust sector and the overall tax burden is shifted onto the “shoulders of hardworking individuals and families”.*

**CCET Response: Energy trusts create more tax revenue than corporations relative to their cash flow and earnings. Income taxes are paid by investors in the trusts with distributed cash flow and the energy trust structure does not shift future tax burdens onto hard working individuals and families.**

Corporations and trusts are both owned by individual investors. Whether you tax individual investors or corporations, it is always real people, individual investors, who bear the tax burden. Corporations like trusts are owned by taxable Canadians, tax-deferred pensions and RRSPs and foreigners. Even if Canadians are not shareholders or unitholders directly, there are very few Canadians that are not indirectly corporate shareholders and trust unitholders through Canada Pension Plan, Quebec Pension Plan, teacher’s pension plans, municipal employees pension plans, corporate pension plans and millions of individual RRSP and RRIF accounts.

The CCET estimates that the Canadian energy trust sector has generated a total of \$7.1 billion in personal Canadian income and withholding taxes in the past five years including:

- \$3.8 billion on distributions to taxable Canadian investors;
- \$2.1 billion on ultimate withdrawal of distributed amounts from tax-deferred accounts; and
- \$1.2 billion withheld on distributions to foreign investors.

*Source: CCET member data*

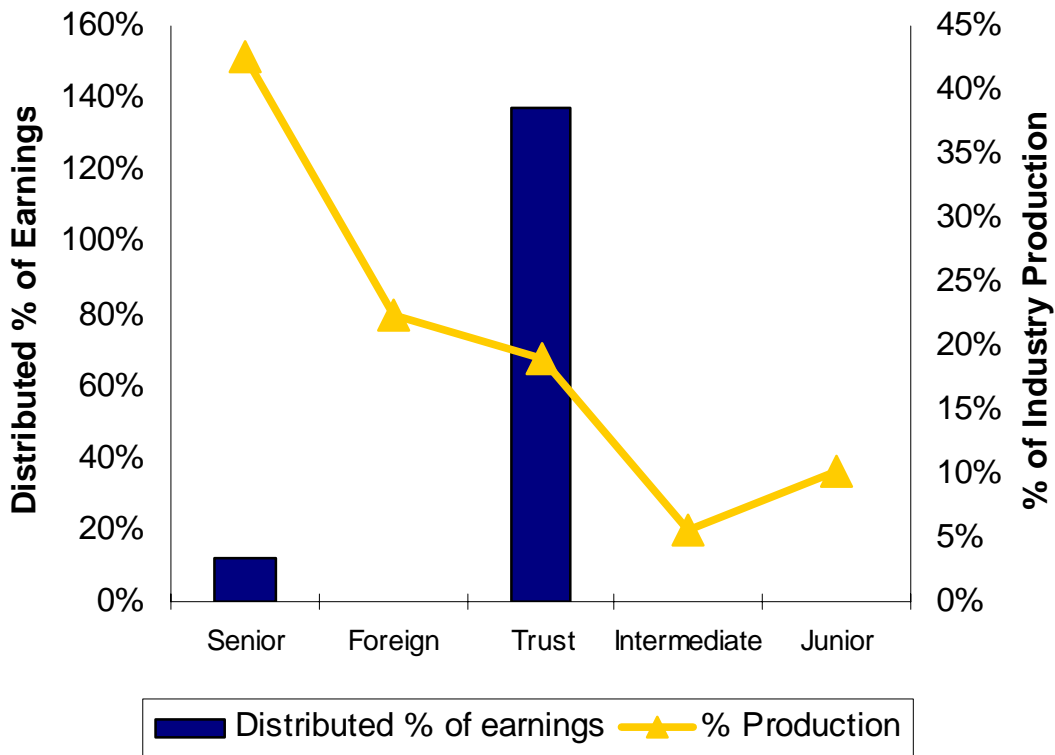
In addition billions of dollars of income taxes related to capital gains to taxable Canadian investors on conversions of corporations to energy trusts and gains generated through the trading of energy trust units have been collected. For example, it is estimated that approximately \$2.9 billion in capital gains were realized on the conversion of Penn West Petroleum Ltd. to Penn West Energy Trust in 2005. Further, the above analysis gives no account to the ancillary activity and economic spin-off from the energy trust sector.

As noted by both Yves Fortin in his November 2006 paper, *Income Trusts and Tax Leakage: Is There a Problem?*, (Appendix B) and Gordon Tait of BMO Nesbitt Burns in his publications of September 2005, *A Perspective on Trusts and Taxes*, (Appendix D) and December 2006, *The Inconvenient Truth About Trusts* (Appendix C), the Government's conclusion regarding fairness of taxation of trusts relative to corporations may have been based on flawed assumptions. Specifically:

- The impact that trusts have on current and future tax revenues is not well understood;
- An underestimation of amounts paid out by Trusts to unitholders and therefore the taxes paid on the latter, through the assumption that trust distributions are based on business income (earnings) when in fact they are much more closely related to operating cash flow ("EBITDA");
- An underestimation of taxes generated within tax-deferred accounts by excluding the taxes by compounding of pre-tax reinvestment;
- An overestimation of tax revenue from public corporations through the assumption that 100 percent of after-tax corporation profits are returned to shareholders in the form of dividends. The actual dividend payout ratio for Canadian public corporations in 2004 was only 28 percent with the remainder retained for reinvestment;
- An overestimation of tax revenue from public corporations through the assumption that all corporations pay the corporate tax rate of 35 percent when in reality Statistics Canada estimated the effective corporate tax rate at about 27 percent in 2004.

The second point regarding dividend/distribution payout ratios is particularly salient in the mature WCSB. The 10 largest publicly traded oil and gas corporations in Canada paid dividends totalling \$2.2 billion in 2005, a ratio of just 12.4 percent of net earnings and **1.8 percent of gross revenue**. In addition 14 of the 25 largest oil and gas corporations in Canada are subsidiaries of foreign corporations that pay absolutely no Canadian dividends. These payout ratios are much lower than the overall Canadian corporate average, demonstrating the inherent incentive in the Canadian tax system for energy corporations to retain cash. Notably the largest corporations are the most prolific dividend payers in the **corporate** energy sector. While payouts for the large companies are small, the juniors pay virtually no dividends at all. In contrast the 10 largest energy trusts distributed **\$2.8 billion or 137 percent of net earnings and 25 percent of gross revenue** to their unitholders in 2005.

### Distribution of Earnings by Sector - 2005



Source: Company reports and CCET member data

The key findings of the Fortin paper with respect to tax fairness were:

- The attempts to quantify alleged tax revenue leakage are unconvincing;
- The Government collects more taxes from taxable portfolios invested in income trusts, than it would if the money was invested in dividend-paying public corporations. This is dramatically so in the energy sector as highlighted above; and
- If the Government really intended to level the tax playing field between trusts and corporations, it would most effectively do so by lowering corporate tax rates and other measures such as the elimination of all taxes on dividends, the reduction or elimination of capital gains tax and the introduction of preferential tax treatment of dividends and capital gains accumulated in tax-deferred accounts.

It is an oversimplification to suggest that hard working individuals do not share the burden of all taxes including corporate and trust taxes. These are the people who ultimately own the corporations and the trusts. If a corporation or trust pays more tax it has less capital available to add value productively, to pay to its employees or to distribute to its shareholders. Investors pay the tax, either directly in the case of trusts, or indirectly in the case of corporations either as cash or capital appreciation. The more important issue is the total tax burden.

The 20 largest oil and gas producing corporations publicly traded in Canada paid only \$4.2 billion in Canadian corporate income taxes in 2005. In the same year energy trusts generated approximately \$1.8 billion in distribution-related income taxes. The trust taxes represented 31 percent of the total tax paid by these two groups including corporate tax and taxes paid by investors on energy trust distributions and corporate dividends, yet represented just 16 percent of the total revenue:

2005	% Ownership <sup>(1)</sup>	% Avg Tax Rate	(\$MM)
<b>Distributions by energy trusts</b>			5,700
<b>Income and Withholding Taxes</b>			
Taxable Canadian Unitholders <sup>(3)</sup>	45%	46%	991
Tax-Deferred Canadian Unitholders <sup>(5)</sup>	19%	46 <sup>(2)</sup>	503
Foreign Unitholders <sup>(4)</sup>	36%	15%	314
<b>Total Tax</b>			<b>\$ 1,808</b>

- 1) Based on weighted average of CCET member estimates
- 2) Tax on deferred accounts will be collected upon withdrawal from tax-deferred accounts
- 3) Assuming 85 percent taxability of distributions to Canadian Unitholders based on average energy trust sector data
- 4) Assumes all foreign ownership is the equivalent of U.S. ownership with 15 percent withholding tax. Actual withholding tax is 25 percent; reduced to 15 percent by tax treaties with certain countries including the U.S.
- 5) While tax on deferred accounts will be collected in the future, the present value of future tax revenues is assumed to at least equal current revenue foregone when considering growth in deferred accounts. (See pages 9-11 of Appendix C).

It would appear that the tax burden has actually historically been shifted from the shareholders of corporations to the owners of energy trusts.

**Government assertion:** *There is a trend toward corporate tax avoidance as corporations feel compelled to convert to income trusts to “capitalize on an available tax rule”.*

**Our response:** **The trend to convert to income trusts is driven not by the desire to avoid tax but rather by an organizations desire to lower its cost of capital. Existing energy trusts have not contributed to an increasing trend in corporate tax avoidance.**

In fact many of the trusts which have converted directly from corporate structures were never materially taxable as corporations but have generated significant tax revenues on distributions following conversion:

Paramount Energy Trust (“PET”) was created by way of a dividend-in-kind from Paramount Resources Ltd. (“PRL”) in 2003. Prior to that, in its 20 year history, PRL paid corporate income tax in only one year totalling \$25.0 million. In the

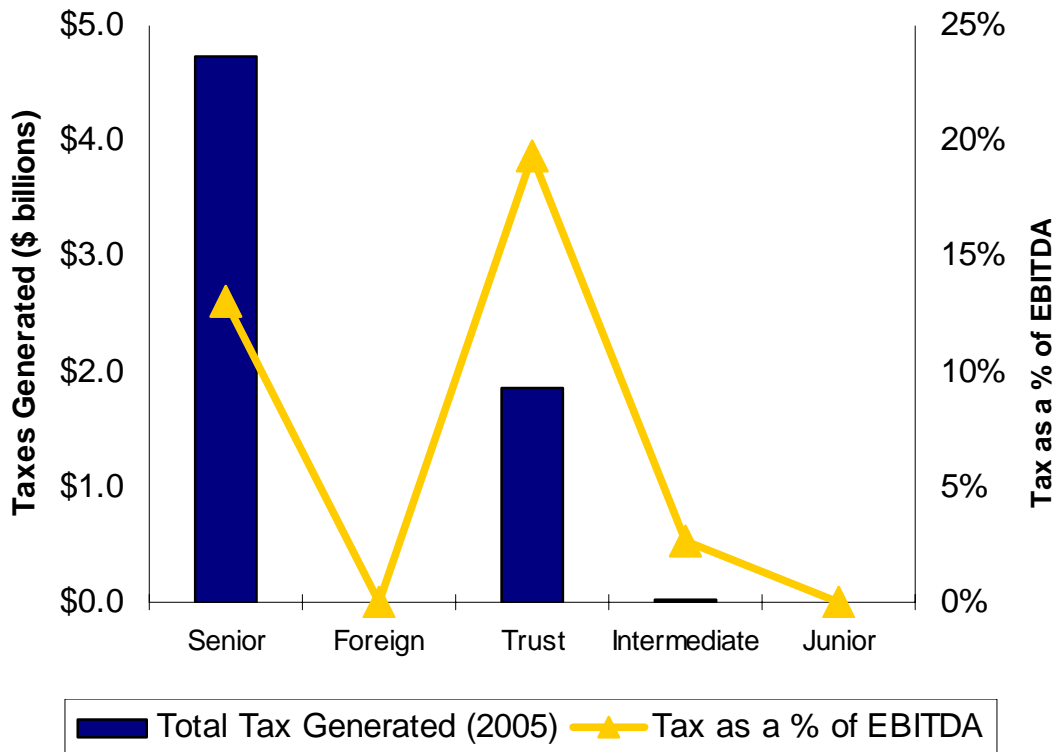
four years of its existence, PET has generated an estimated \$200 million in Canadian personal income and withholding tax.

Another case in point is that of Baytex Energy which operated as an oil and gas corporation for 10 years prior to conversion to an energy trust in 2003. Through 10 years operating in a corporate legal structure, Baytex paid no corporate income tax and paid no taxable dividends. In three years as a trust Baytex has paid \$386 million in taxable distributions which were or ultimately will be taxed.

In its history of operation as a corporate entity prior to its reorganization into Bonavista Energy Trust in 2003, Bonavista Petroleum Ltd. paid corporate income taxes totalling \$17.1 million. Since the reorganization, Bonavista Energy Trust has paid \$794 million in taxable distributions which were or ultimately will be taxed.

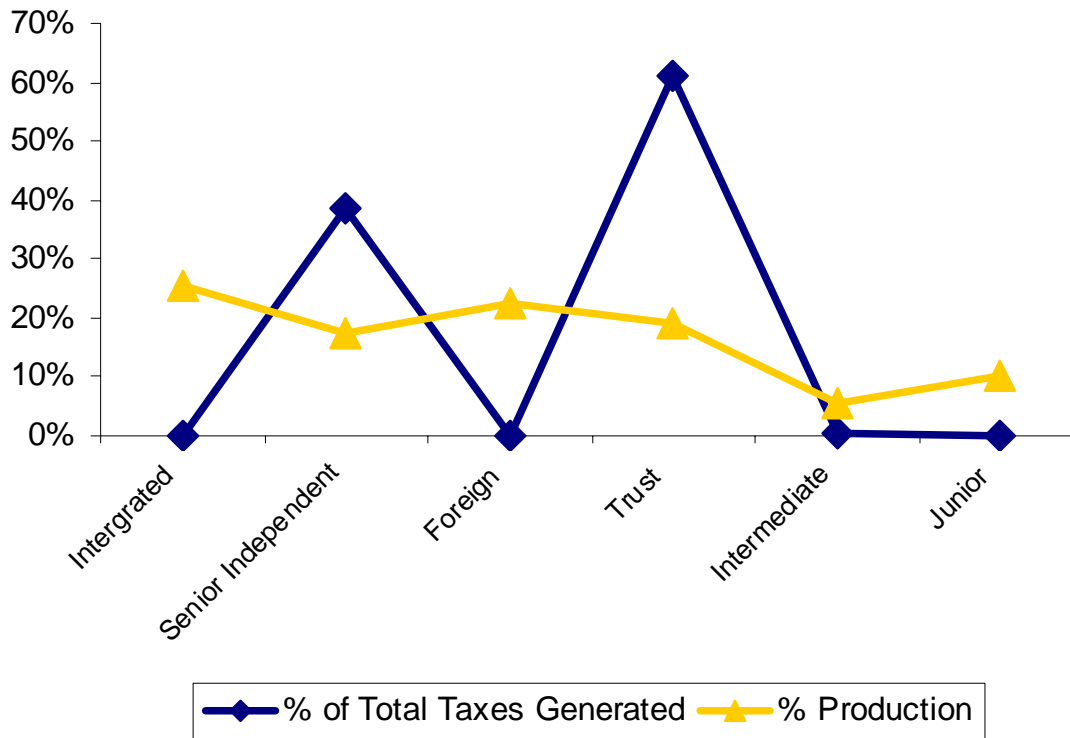
The 20 largest oil and gas producing corporations publicly traded in Canada paid only \$4.2 billion in Canadian corporate income taxes in 2005, representing just 11.4 percent of EBITDA and 4.4 percent of gross revenue. For the five year period ended 2005, the 20 largest oil and gas producing corporations publicly traded in Canada paid only \$14.5 billion in Canadian corporate income taxes, representing just 11.1 percent of EBITDA and 4.2 percent of gross revenue. In 2005, oil and gas royalty trusts generated taxes of approximately \$1.8 billion, representing 19.4 percent of EBITDA and 10.3 percent of gross revenue. This does not suggest a trend towards overall tax avoidance through the energy trust structure.

The following graph depicts estimated total corporate and personal taxes, including taxes on trust distributions and corporate dividends, generated by each sector of the energy industry in 2005 and the related percent of EBITDA such taxes represented. Note that tax paid data for private Canadian subsidiaries of foreign corporations is generally not publicly disclosed. These entities account for approximately 22 percent of the production in the WCSB.



Source: Company reports and CCET member data

The following graph depicts the percentage of total corporate and personal taxes, including taxes on trust distributions and corporate dividends, generated by each sector of the energy industry in 2005 and the related percent of EBITDA such taxes represented. Note that tax paid data for private Canadian subsidiaries of foreign corporations is generally not publicly disclosed and the data for integrated producers include taxes paid on downstream operations including refining and marketing. These entities have therefore been excluded from the tax paid percentages.



Source: Company reports and CCET member data

## Provincial Implications

Two issues are raised in the Proposals with respect to FTEs for Canada's provinces:

- FTEs affect provincial revenues more significantly than federal revenues because the income that a foreign investor earns through an FTE is not subject to provincial tax; and
- To the extent that an FTEs investors reside in a province other than where the FTE operates, tax revenue is shifted between provinces.

With respect to the first point, again it must be stressed that, in the energy industry, the withholding tax from foreign investors comes to Canada as a result of their infusion of much needed capital into our industry without any commensurate burden being placed on our social services, health care systems, education or infrastructure. The benefits from increased activity and productivity in any given province accrue to the provinces where trusts operate through increased royalties, higher employment, capital, operating and administrative spending and other taxes. These benefits would arguably, vastly outweigh provincial tax revenues foregone, especially given the multiplier effect on local economies. Notwithstanding this, as withholding tax occurs at the time of distribution at the FTE level by the trustee, an agreed upon percentage of the foreign withholding tax revenue could easily be flowed to the province(s) where an FTE operates.

It can be argued that the second point is beneficial to the majority of Canadians in that western “resource income” is redistributed across the country in that more than 75 percent of energy trust units are held by investors outside the province of Alberta where all of the energy trusts are located. As a result, all provinces in Canada now benefit directly from western Canadian resource revenue which would not be the case without trusts.

## **Taxation Summary**

The foregoing discussion highlights the relatively small amount of taxes paid by corporations in the oil and gas industry. This is an irrefutable fact and is a direct result of the capital intensive nature of the business and the tax incentives available to corporations. Foreign-controlled companies account for a significant component of the companies which pay minimal corporate tax. As previously stated, the trust sector has repatriated approximately \$10 billion in assets from foreign corporations in the past 10 years. Cash flow from these properties immediately generated distributable income and therefore taxes for the federal government and all provinces in Canada based upon residency of the unitholders. Had these properties remained within the foreign corporation, significantly less tax would have been paid in Canada.

# Benefits to Canada of the Energy Trust Sector

## Economic Benefits

The economic benefits that energy trusts provide to Canadians are many. Examples of these benefits are listed below:

- In 2006 alone, energy trusts will make over \$3 billion in direct payments to governments including royalties, property taxes and land sale bonuses, in addition to the estimated \$2.4 billion in personal taxes on distributions;
- The contribution to the economy is significant with combined administrative expenses and operating expenditures of \$6 billion;
- In 2005, energy trusts spent almost \$4 billion to drill 5,431 wells (25 percent of wells drilled in Canada);
- Energy trusts have invested over \$15 billion in the last five years on revenue of \$65 billion;
- Job creation: both directly, indirectly and through the ripple effect of Trust activities into the economy;
- Increased focus on research and development as energy trusts are on the leading edge of innovation and technology initiatives to increase hydrocarbon recovery from mature fields, CO<sub>2</sub> injection for enhanced oil recovery is an example;
- Community involvement is evident everywhere trusts operate;
- Environment, health and safety considerations are integral to the business: trusts have an impressive record in each of these areas.

*Source: CCET member data*

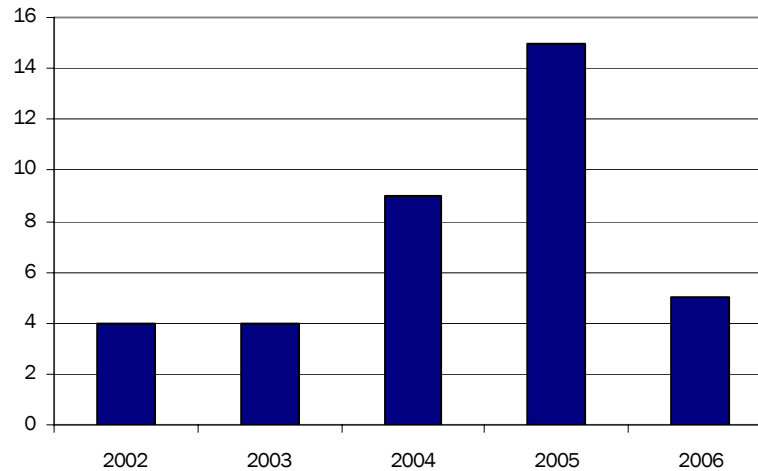
## Benefits Shared Within the Canadian Economy

The trusts have “shared” their low cost of capital through their synergistic relationship with the junior exploration companies, the large E&P companies, and the service sector. As discussed previously, trusts purchase assets from corporations, allowing the corporations to redeploy this capital back into their businesses. The corporations have received higher values for their oil and gas properties as a result of the trusts’ acquisition activity which is based on an attractive cost of capital.

The trusts have been particularly beneficial to junior oil and gas companies. Many junior management teams do not have the interest or skill sets required or the desire to run a large company, and instead prefer to focus on what they do best, which is running smaller companies. These management teams create great value in taking their companies from zero production up to several thousand barrels per day. After a strong initial period, they often have difficulty maintaining a high rate of growth. For many juniors, they prefer to sell their existing companies before hitting the wall and start a new company in an effort to replicate their previous success on a smaller focused asset base. The royalty

trusts provide the ideal exit strategy for these management teams. When juniors sell themselves to a trust, often a junior E&P is “spun out” with an exploration land base and a small amount of production so that these management teams have a platform on which to build.

**Number of junior growth exploration companies created from royalty trusts**



Source: Canaccord Adams, Company Reports

## Benefits Shared with Municipal, Provincial and Federal Government

By increasing investment in mature properties substantial incremental production has resulted from the transfer of ownership from large corporations to trusts whereby the trusts have increased crown royalties, crown lease rentals, employment and personal tax revenues, crown land sale bonuses, and municipal property taxes.

In 2006, the energy trust sector expects to make \$3.3 billion in direct payments to government sources, not including the taxes collected from distributions:

<b>Estimated Direct 2006 Tax Revenues (\$ millions)</b>	2006 est.	Total Last 5 Years
Crown royalties	\$ 2,593	\$ 7,279
Crown lease rentals	90	147
Property taxes	155	412
Crown land sale bonuses	147	294
Capital & large corporate taxes	72	303
Personal tax paid by staff (T4 taxable income x 40%)	240	N/A
<b>Total</b>	<b>\$ 3,297</b>	<b>&gt; \$8,435</b>

Source: CCET member data

The Canadian energy trust sector currently employs over 8,000 people throughout western Canada, with a large concentration in the almost 60 head offices in Calgary. The jobs in Calgary are in general, highly skilled technical professional roles. In addition to direct employees, consultants are employed to support field operations. The industry touches literally tens of thousands of suppliers and service providers across Canada as well as being responsible joint venture partners to almost every oil and gas entity in Canada. Further, there is a ripple effect through the economy as a result of the activities of energy trusts.

## **Benefits Have Led to International Expansion of the Sector**

Not only have the trusts been instrumental in repatriating Canada's resources, but they have also been expanding internationally. Enerplus, Vermilion, Provident, Primewest and Enterra have expanded internationally, acquiring properties in jurisdictions such as the U.S., France, Australia, and the Netherlands, extending the reach of Canadian entrepreneurship.

In the last five years, Canadian energy trusts have acquired over \$1.7 billion in foreign oil and gas properties. Cash flow from these foreign assets form part of the distributions made to Canadian investors providing Canadians with taxable income from foreign oil and gas production. Through taxation of distributions to Canadians made by firms such as Vermilion and Enerplus, the Canadian government will receive tax on foreign oil and gas production.

Approximately \$459 million in cash flow from international sources is now supporting the cash flow and distributions of Canadian energy trusts.

## **Research and Development**

Contrary to what some may believe, Canada's energy trusts are active participants in research and development on new extraction, processing, and transportation technology. As the industry is focused on optimization and increasing production from existing reserves, many individual trusts are participating in and investing heavily in a wide variety of research projects including:

- low pressure Steam Assisted Gravity Drainage (SAGD);
- enhanced Oil Recovery ("EOR") through carbon dioxide ("CO<sub>2</sub>") flooding – Penn West operates the largest commercial CO<sub>2</sub> flood in Alberta (Joffre) as well as a pilot CO<sub>2</sub> flood in the Pembina area (Canada's largest light/medium oil pool);
- a CO<sub>2</sub> Sequestration and Enhanced Methane Production (CSEMP) pilot in conjunction with industry and government partners;
- Gas Re-injection and Production Experiment (GRIFE) – a project to inject the flue gas from gas compressors into the gas reservoirs overlying bitumen

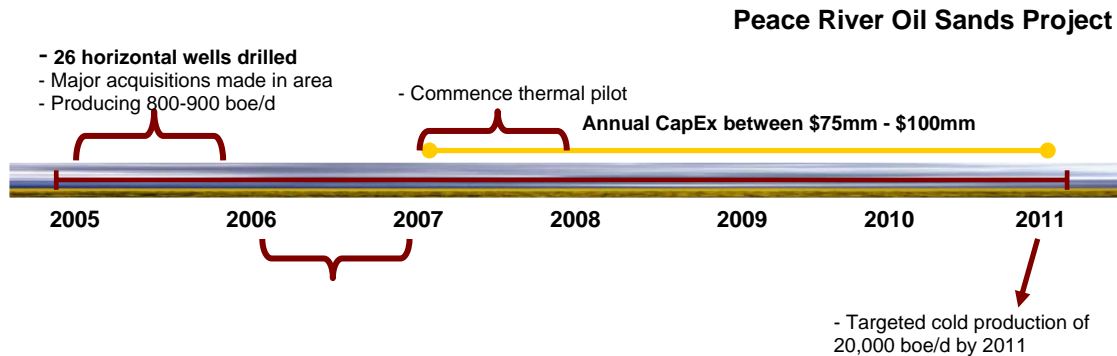
reservoirs. This will test whether this is a viable option to “re-pressurize” the reservoir, aiding in the recovery of additional bitumen reserves, as well as reducing the amount of carbon monoxide being emitted to the atmosphere;

- Solvent injection to increase recovery from heavy oil reservoirs;
- Polymer/ASP flooding in medium/heavy oil reservoirs;
- Brine injection to minimize the detrimental impact of clay swelling in reservoirs; and
- many additional production optimization and recovery initiatives.

Canada is a world leader in exploitation technologies which have been exported worldwide. These processes often have significant environmental benefits and trusts are actively involved in developing these technologies.

## Oil Sands

The Peace River Oil Sands Project is an example of a grass-roots development in one of Canada’s most prolific oil sands deposits. Penn West plans to invest in several pilot projects to ascertain which thermal production technique (e.g., cyclical steam simulation, steam-assisted gravity drainage, and combustion) is most suitable for increasing the recovery factor in this area. This kind of research and development is commonplace at many energy trusts.



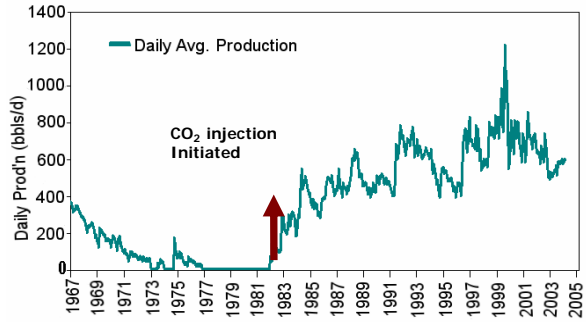
## CO<sub>2</sub>

The Joffre Field was shut-in in 1977. However production was revived in 1982 with a CO<sub>2</sub> miscible flood. Penn West’s current expansion at Joffre is expected to take production from 600 BOE/d to 1,000 BOE/d. Continual rejuvenation of mature pools increases production and provincial royalties.

Penn West’s expertise from the Joffre field has provided direct insight into a pilot project at Pembina, Canada’s largest light/medium oilfield. Penn West

estimates net incremental oil from CO<sub>2</sub> flooding in the Pembina Cardium Pool to their interest, of 150 million to 400 million barrels.

JOFFRE	Cumulative Recoveries	Cumulative Production (mmbbls)
Waterflood	45%	18.3
Tertiary to date	10%	4.0
Ultimate tertiary	15%	6.2



In addition to the above noted research projects, many of the trusts are using leading edge drilling and completion technology. The first horizontal well completed in Canada using Haliburton’s “Surgifrac” technology previously developed for North Sea operations was by a trust at Dawson, in northeast British Columbia.

## Community Involvement

In 2006, Canadian energy trusts made over \$9.9 million in charitable donations, bringing the five year total donations to over \$22 million. Significant sponsorship was extended to organizations such as the United Way, Alberta Children’s Hospital, Tom Baker Cancer Centre, Southern Alberta Institute of Technology and STARS air ambulance to name a few as well as to various arts, education, youth activities, sports facilities and numerous other endeavours in the areas in which the trusts do business. Further, charitable contributions by trust investors using distributions would indeed be significant, although impossible for the Coalition to quantify. It is certain that with additional income and the opportunity to compound the return on the investment prior to taxation, contributions to charities by unitholders will indeed be more significant in the income distribution and flow through taxation scenario.

Just as important as the monetary impact we make on charitable organizations is the donation of our employee’s time and energy. Many trust employees are active leaders on the Boards of Directors of non-profit organizations. In addition, the staff have dedicated many volunteer hours to organizations such as Habitat for Humanity, food banks and centers for the homeless.

## Environment and Health & Safety Achievements

Many of Canada’s energy trusts are among the nation’s leaders in environment, health and safety in the energy industry. Several members have been awarded “Gold Level” status, the highest level attainable, by the Canadian GHG

Challenge Registry as well as receiving “Platinum” recognition from the Canadian Association of Petroleum Producers for achievement in community, environment, health and safety. We also have members who have been recognized with “The Work Safe Alberta, Safety Performer Awards” for their success in preventing work place accidents.

## Unintended Consequences

Whenever a policy is implemented to address particular issues within a broad sector of the economy, a “one size fits all” solution such as the Government’s October 31st announcement can often lead to unintended consequences in a particular sub-sector or for a specific sub-set of investors. The Government’s plan as announced on October 31<sup>st</sup> effectively destroys the Canadian oil and gas royalty trusts and will have unintended consequences for investors, the oil and gas sector as a whole, the Canadian economy and the environment.

### Income Investors – Where Do They Turn?

Millions of Canadians have earned high returns in the trust market through their ability to participate in oil and gas ownership with limited exploration risk. Without an energy trust market, this type of investment opportunity will be lost to all but institutions and wealthy investors in Canada and to private equity investors abroad.

From an investment perspective, energy trusts match the investment objectives and risk profiles of a large segment of the investing population. The energy trust sector has provided billions of dollars in distributions to investors who were looking for alternatives to the low returns provided by government bonds and guaranteed investment certificates, as well as significant capital appreciation. It can be demonstrated that energy trust investors have received higher total returns on their investments than investors in conventional equities and at a lower risk.

According to BMO Capital Markets, an investment in the BMO CM Trust Composite Index has higher Sharpe ratios or higher risk-adjusted returns than an investment in the S&P/TSX Composite Index over the period from January 1996 to October 2006.

#### Total Returns and Volatility (January 1996 to October 2006)

	Average Annual Compound Total Return %	Volatility (Annual Std. Dev.) %	Sharpe Ratio (1)
BMO CM Trust Composite	18.8	13.0	1.06
BMO CM Royalty Trust Index	23.4	19.9	0.93
BMO CM Income Trust Index	15.7	12.6	0.85
S&P/TSX Composite Index	10.8	16.1	0.36
S&P/TSX E&P Index	16.9	26.9	0.44
10 yr. Gov't of Canada Bond	9.4	7.4	0.59

(1) Assumes a risk-free rate of 5%.  
Source: BMO Capital Markets

On average 30 to 35 percent of Canadian retail ownership of Canadian energy trusts is held in tax-deferred accounts – RRSPs and RRIFs, and a significant percentage of the remainder are held by investors who use the monthly income from these investments to supplement their retirement income. As less than one-third of Canadians have a defined benefit pension plan, the vast majority of Canadians are dependent on investment income from their RRSPs and taxable investment accounts to support themselves in their retirement.

The proposed measures will have a significant negative impact on retirees' incomes. Under the proposed legislation, a pension plan beneficiary or someone with a RRIF that has an income trust investment would see every \$1.00 of cash distributions first taxed at 31.5 percent at the trust level. As the income is paid out to the pension beneficiary or trust unitholder, up to an additional 46 percent (top marginal rate) in individual tax would be levied on the remainder. This works out to be an effective tax rate of up to 63 percent, leaving the pensioner or retiree with only 37 cents in their pocket for every one dollar of cash distributions.

### Maintaining the Cash Flow Stream

		Initial Trust Investment	Value Decline	Revised Trust Investment	Alternate Investments	
Invested Capital		\$100,000	31.5%	\$68,500	\$68,500	\$68,500
Cash Yield		9.5%		9.5%	4.0%	5.0%
Annual Cash Flow		\$9,500		\$6,508	\$2,740	\$3,425
After Tax: Income						
Top	46%	\$5,130			\$1,480	\$1,850
Middle	36%	\$6,080			\$1,755	\$2,190
Bottom	26%	\$7,030			\$2,030	\$2,535
After Tax: Dividend						
Top	22%			\$5,130	\$2,165	\$2,705
Middle	12%			\$6,080	\$2,560	\$3,200
Bottom	2%			\$7,030	\$2,960	\$3,700

Source: Ministry of Finance, CCH and RBC CM estimates

The unintended consequence of this punitive tax level on retirees is that they may look to other high-yield investments to replace Canadian income trusts, many of which are U.S. based - such as the U.S. high yield debt market, U.S. Master Limited Partnerships “MLPs” and U.S. exploration and production Limited Liability Corporations “LLCs”. The reality is few investments pay distributions to the extent of the trusts, and many investors require monthly cash flow streams to supplement their current income. To the extent that they replace income trusts with other products providing lower yields, investors may have to sell investments to make up for the income gap – a gap which the

above table shows can be very large. Both of these actions result in much needed capital being taken out of the Canadian market.

## **Private Equity/Large Institutional Investors**

Private equity and large institutional investors have always been significant investors in Canadian resource properties and infrastructure assets. As an unintended consequence of the October 31<sup>st</sup> announcement, these investors will once again have preferential access to Canadian resource properties and infrastructure at a lower price, as they still retain their ability to set up private trusts that are not impacted by the new tax. The private investment arms of several large pension funds and large U.S. institutions specializing in leveraged buy-outs, are reportedly already investigating opportunities in the resource sector due to the sharp drop in value post October 31<sup>st</sup>. The end result is that private equity and large institutional investors have the ability to avoid paying the proposed tax while individual Canadian investors (many of whom are seniors) will have no opportunity to avoid the tax.

## **Oil and Gas Sector**

### **Value Destruction through Over-Investment?**

The income trust market serves to redistribute cash flow from mature industries or businesses that would otherwise be trapped inside non-distributing entities. Trapped capital leads to over-investment in slow growth businesses and to ever-diminishing rates of return on invested capital. The theory behind a trust is that the market is more efficient at allocating excess capital than a manager in one particular business or industry. Equity investors reward management teams for growth, hence management's incentive is to re-invest all available capital in an attempt to grow the business. But in an economy that is growing at two to three percent annually, all business cannot grow at the eight to ten percent rates that equity investors typically demand. In an attempt to grow at these rates, some management teams will make poor capital deployment choices and destroy value and productivity.

This is particularly true in the oil and gas business in western Canada. As mentioned elsewhere in this report, the WCSB is a declining conventional oil and gas basin where each incremental investment provides a smaller and smaller return. This is not a problem unique to Canada, in a recent Lehman Brothers report ("Top of Cycle – Significant Value Destruction in 2006?", October 3, 2006), senior oil analyst Tom Driscoll estimates that 15 of the largest North American based exploration and production companies will grow by an estimated five percent in 2006, but will do so by destroying U.S. \$15 billion in value. Clearly, this is an industry which needs the investment discipline that monthly distributions to unitholders provide. An unintended consequence of the

tax on trusts may be the conversion of trusts back to corporations resulting in reduced productivity as managers attempt to grow production in a declining basin.

## **Junior Oil and Gas Companies**

As discussed in other sections of this report, the junior E&P sector operating in western Canada consists of a large group of small entities harvesting cash flow from existing properties as well as a vibrant sub-group aggressively investing to grow their businesses. While not all companies can successfully grow their businesses, there is a group of management teams who have shown the ability to effectively grow their business through judicious deployment of capital. The business model for these growth oriented junior companies has evolved in the recent past to include an exit strategy which consisted of the sale of most of their assets to a trust or conversion to a trust with a new junior “ExploreCo” spinout to re-start the growth process. Typically, these management teams prefer to sell before they “hit the wall” and are unable to continue high rates of growth.

This direct line of sight to a near-term liquidity event for investors generated greater interest in the junior sector and greater access to capital which resulted in increased valuations and hence a reduced cost of capital for that sector. The government’s October 31st announcement has introduced significant uncertainty with respect to the business model for the junior sector since the conversion option is gone, blurring the line of sight to a liquidity event. In addition, the trust sector’s material increase in its cost of capital as a result of the announcement has reduced the value the sale of the assets could achieve in the future.

The WCSB is gas prone (over 70 percent of drilling is gas-directed) and the recent decline in natural gas prices has hurt the valuations of the junior sector; the government’s October 31st announcement has reduced their values even further. Recent discussions with members of the Small Explorers and Producers Association of Canada (“SEPAC”) indicate that access to capital has been materially affected with some companies trying to raise money for their 2007 capital program falling well short of their targets (including some who weren’t able to raise any new capital).

The growing junior companies generally spend well in excess of their cash flow using a combination of debt and new equity. If these companies now have to live within cash flow, industry activity will be reduced. With the decline in gas prices, debt to cash flow ratios in the junior sector have increased sharply and with reduced access to capital at this time, a number of companies are running into debt covenant issues with their lenders.

An unintended consequence of the government's announcement has been the drop in share value experienced by this small business component of the economy by eliminating conversion or sale to a trust as a viable exit strategy.

## **Loss of Head Office Jobs in Canada**

Several analysts have speculated that the royalty trusts are now vulnerable to acquisition by U.S. companies as the sharp drop in valuations has driven trading prices down below net asset value for some of the trusts. While this may be true for some trusts, many trusts do not have assets that would be attractive to U.S. companies, however many of the assets could be attractive to either U.S. infrastructure MLPs or U.S. LLCs, both of which have a lower cost of capital than corporations. Contrary to the government's statements regarding the U.S. having eliminated this structure, it is actually alive, well and expanding its activities and may well look north to Canada in search of quality assets.

The trusts have been a significant contributor to bringing mind and management of Canadian oil and gas assets back to Canada, reversing a trend towards increased foreign control. With trusts having a materially increased cost of capital and associated reduced values, there will likely be an increase in foreign control of Canada's energy resources. In addition, the tax changes will likely lead to considerable consolidation within the sector. In a recent survey of Canadian executives by Deloitte, 87 percent believe that the number of income trusts will have dropped from the current 256 to 100 or less within four years. All of this points to a loss of head office jobs here in Canada.

### **Higher cost of capital and lower access to capital translates to higher project hurdle rates**

The imposition of a tax at the trust level imposes a significant amount of double taxation on Canadian tax-deferred investors and a dramatic decrease in the after tax return to foreign investors, making investment in Canadian royalty trusts significantly less attractive to these investors. While the taxable Canadian investor is relatively unaffected, this segment of investors is not large enough to make up for the loss of value created by the selling of royalty trusts by tax-deferred and foreign accounts.

Over the past five years, Canadian royalty trusts have raised over \$17 billion in capital through equity offerings, primarily from income-seeking investors, bringing much needed capital into the Canadian oil and gas industry. As income-oriented investors are unlikely to be attracted to equity investments, an unintended consequence is that less capital will be available for oil and gas investments in western Canada.

## Environment

In recent years, the senior producers in the WCSB have divested of many of their mature oil properties which are typically characterized by low per well productivity and high unit operating costs. These are often long life properties which are attractive to trusts with a sustainability model since annual decline rates are significantly lower than average for the basin. Today, many of Canada's legacy conventional oil properties are owned and operated by trusts.

Canada's greenhouse gas ("GHG") challenges are well documented. Seven of Canada's top ten point source emission sites are in Alberta with more proposed as the oil sands production expands. Moving forward, both provincially and federally, the governments have significant GHG emission reduction targets.

Western Canada's largest conventional oil pools are excellent candidates for EOR activities through CO<sub>2</sub> injection.. Trusts are operators of many current and potential future CO<sub>2</sub> EOR floods in Alberta:

Swan Hills:	Pengrowth, ARC, Penn West
Pembina:	Penn West, ARC, Enerplus and others
Joffre:	Penn West
Redwater:	ARC, Penn West
Judy Creek:	Pengrowth

The original oil in place ("OOIP") in these reservoirs exceeds 10 billion barrels with potential incremental recoveries of 5 to 15 percent.

Pembina is Canada's largest conventional oil field with almost 8 billion barrels of OOIP. Over 50 percent of the CO<sub>2</sub> EOR prospective areas within Pembina are operated by two trusts, ARC and Penn West, both of whom are actively moving forward studies directed towards implementing CO<sub>2</sub> injection projects. In addition to Pembina, another field believed to have significant potential for CO<sub>2</sub> EOR is Redwater which is northeast of Edmonton and located in close proximity to existing and proposed new upgraders in the Fort Saskatchewan area. In excess of 95 percent of Redwater is owned and operated by the same two energy trusts, ARC and Penn West.

As recently as 12 months ago, Imperial Oil and ExxonMobil divested their operated interests in Redwater and the largest production unit in Pembina. Despite having the greatest exposure to GHG reduction initiatives, many of the major oil sands operators have divested their interests in the best candidate reservoirs for CO<sub>2</sub> EOR activities or, at the very least, CO<sub>2</sub> sequestration. It is estimated that if CO<sub>2</sub> EOR initiatives are successful in Pembina and Redwater, in excess of 30,000 tonnes per day (11 million tonnes annually) of CO<sub>2</sub> could be removed from the atmosphere and injected into these reservoirs. This represents the emissions of at least five upgraders/refineries the size of the current Shell Scotford refinery.

EOR operators will need to invest billions of dollars in infill drilling and facility upgrades in these older oil fields. Since the senior producers have divested their interests in these fields, trusts will be leading the CO<sub>2</sub> EOR initiatives in Alberta; in order to do so access to significant incremental capital from investors throughout North America and abroad on attractive terms to justify the investment is required. An unintended consequence of the taxation on trusts may be the loss of an opportunity to remove 11 million tonnes per year of CO<sub>2</sub> emissions from large final emitters in western Canada as these properties become exposed to the higher cost of capital associated with the corporate structure. At the very least these projects will be delayed since the early projects were expected to come onstream in 2010-2012, which is when the Proposals are scheduled to be implemented. More likely, many won't proceed at all.

Appendix F is a copy of a presentation by ARC Energy Trust to a recent Petroleum Technology Association of Canada conference on CO<sub>2</sub> capture and sequestration which discusses the issues.

## Measuring the Cost to Canadians

The Canadian government is running the risk of stranding a significant portion of its energy wealth, from mature conventional oil & gas properties, in a global environment where they may be underdeveloped. Capital reinvestment will slow with the implementation of the Proposals. Reservoirs will ultimately revert back to their natural depletion rates. The pace of new technology for extraction / measurement / production will slow. Jobs will be lost. Government royalty and tax revenues will decline. Donations to charitable organizations will be reduced.

Through a recent survey of Canadian energy trusts, the CCET gathered statistics that help shed some light on the size and significance of the Canadian energy trust sector. As of late November 2006, the Energy Trust Index had decreased 15 percent since the Proposals were announced before recovering slightly on commodity price strength. It is not unreasonable to assume that the index may decline 30 percent as the four-year transition period approaches. To help demonstrate the economic dislocation and disruption of this proposal, we have discounted some of the key 2006 energy trust measures by 30 percent, 20 percent and 10 percent to demonstrate the possible impacts on key elements:

<b>Potential Direct Negative Impact before GDP multiplier</b> (\$ billions)	<b>30% reduction</b>	<b>20% reduction</b>	<b>10% reduction</b>
Capital spending (\$7 billion)	\$2.1	\$1.4	\$0.7
Distributions to unitholders (\$8 billion)	\$2.4	\$1.6	\$0.8

Direct payments to governments* (\$3 billion)	\$0.9	\$0.6	\$0.3
Operating/G&A costs or payments to suppliers (\$6 billion)	\$1.8	\$1.2	\$0.6
<b>Total estimated loss</b>	<b>\$7.2</b>	<b>\$4.8</b>	<b>\$2.4</b>

\* Crown royalties, rentals and bonuses, property tax, capital tax, personal tax on salary/benefit but excludes personal tax on distributions

This approach measures only changes to direct spending. It does not measure the “spin-off” or ancillary benefits that arise as a result of the trust’s economic activity. We are not certain of what the “multiplier effect” would be, but for illustration assume that for every dollar spent by the oil and gas industry there is a 2.5 times multiplier effect on Canada’s GDP. Just a ten percent reduction in capital spending, distributions, direct payments to governments and operating/G&A costs would result in a direct loss of \$2.4 billion and an indirect loss of perhaps \$6 billion to the economy. A thirty percent reduction, which might be felt by 2011, would result in a \$7.2 billion direct loss and an indirect loss of perhaps \$18 billion.

Canada’s conventional oil and gas reserves are declining every year. Reducing capital investment only serves to accelerate these production decline profiles. The proposed distribution trust tax may go to government revenues initially, but we believe there will be a lower taxable revenue base over time.

Commodity prices will also increase with lost supply.

### **Reduced capital = higher decline rates = lower supply = higher prices**

This means:

- higher gasoline prices at the pumps;
- higher costs to heat our homes with natural gas, oil and propane;
- Higher inflation as energy prices impact the cost of goods and services; and
- More North American dependence on foreign sources of energy.

It is not clear how this outcome will achieve the stated objective of “ensuring Canada’s economy continues to grow and prosper”.

## Flow Through Entities in the United States

The Minister of Finance commented in his announcement of the proposals, “Clearly, Canada is out of step in its treatment of income trusts. The structure being used in this country was shut down in the United States and Australia”. This statement is not correct as it relates to resource industries in the U.S. The U.S. faced a similar situation in the 1980’s with a wide range of businesses converting into publicly traded Master Limited Partnerships (“MLPs”). In 1987, Congress enacted legislation dictating that MLPs be treated as corporations for federal income tax purposes with two important exceptions:

- A “Qualifying Income Exception” provided that MLPs would continue to be treated as partnerships if 90 percent or more of its gross income consisted of “Qualifying Income”; and
- A “Grandfather Rule” allowed MLPs which did not meet the Qualifying Income Exception to continue to operate as Flow through Entities (“FTEs”) for 10 years.

Qualifying Income included:

- Certain types of passive income such as interest, dividends and real property rents (i.e. REITs); and
- A broad category of income related to natural resources including income derived from exploration, development, mining, production, processing, refining transportation or marketing of any mineral or natural resources (including oil, gas, or products thereof, fertilizer, geothermal energy and timber).

As a result, the U.S. oil and gas exploration, development and production business continues to qualify for MLP treatment as an FTE not subject to entity level taxation but rather taxed in the hands of its owners. The exception was made for the natural resources industries to maintain the low cost of capital that existed for the MLPs since failure to do so could invite foreign ownership of America’s natural resources. It was also intended to encourage investment in U.S. natural resources and energy infrastructure.

MLPs in the U.S. have continued to grow in size and number since 1987. A significant number of MLPs in pipelines, gathering and storage currently operate in the U.S.. Numerous royalty trusts also operate in the U.S. however they have not recently been “going concern” enterprises. More recently, upstream (i.e. exploration, development and production) limited liability corporations (“LLC’s”) and partnerships have been created modeled after Canada’s very effective and efficient energy trust sector. While it is correct that there are not a large number of this latest generation of FTE’s in existence at this time, they are growing in size and number. In mid-December, the largest LLC announced an acquisition which would result in a 50 percent increase in its

size. We are aware of numerous additional LLC's which are in varying stages of "coming to market".

(Dollars in millions)

IPO Year		Market Cap	Enterprise Value	IPO Year		Market Cap	Enterprise Value
<b>Pipelines, Gathering and Storage</b>				<b>Coal</b>			
1992	Kinder Morgan Energy Partners, L.P.	\$17,615	\$22,924	2002	Natural Resource Partners	\$1,492	\$1,739
1998	Enterprise Products Partners, L.P.	13,675	18,322	1999	Alliance Resource Partners, L.P.	1,484	1,574
1996	Energy Transfer Partners, L.P.	8,179	10,533	2001	Penn Virginia Resource Partners, L.P.	1,168	1,477
1998	Plains All American Pipeline, L.P.	5,787	8,223	<b>Shipping</b>			
1993	ONEOK Partners, L.P.	5,612	7,594	2005	Teekay LNG Partners L.P.	\$1,088	\$2,483
1990	TEPPCO Partners, L.P.	4,260	5,843	2004	K-Sea Transportation Partners, L.P.	364	557
1991	Enbridge Energy Partners, L.P.	3,464	5,368	2004	U.S. Shipping Partners L.P.	262	406
2001	Magellan Midstream Partners, L.P.	3,384	4,185	<b>Upstream</b>			
2005	Boardwalk Pipeline Partners	3,083	4,127	2006	Linn Energy LLC	\$1,076	\$1,378
2001	Valero L.P.	2,937	4,044	2006	BreitBurn Energy Partners L.P.	471	519
1986	Buckeye Partners, L.P.	2,180	3,144	2006	EV Energy Partners L.P.	86	90
2002	Crosstex Energy, L.P.	1,410	2,232	Filed	Constellation Energy Partners LLC	na	na
2002	Pacific Energy Partners, L.P.	1,462	2,080	Filed	Atlas Energy Resources	na	na
2002	Sunoco Logistics Partners, L.P.	1,563	1,962	<b>U.S. Royalty Trusts</b>			
2006	Regency Energy Partners, LP	1,251	1,821	1980	San Juan Basin Royalty Trust	\$1,776	\$1,767
2002	Markwest Energy Partners	1,082	1,655	1989	BP Prudhoe Bay Royalty Trust	1,562	1,561
2000	Atlas Pipeline Partners	837	1,110	1999	Hugoton Royalty Trust	1,070	1,063
2005	Williams Partners LP	854	977	1980	Permian Basin Royalty Trust	769	764
1999	TC PipeLines, LP	586	893	1982	Sabine Royalty Trust	711	705
2004	Holly Energy Partners	691	864	1972	Texas Pacific Land Trust	336	335
2005	DCP Midstream Partners LP	596	701	1992	Cross Timbers Royalty Trust	291	289
2002	Martin Midstream Partners L.P.	456	602	1994	Dominion Resources Black Warrior Trust	238	238
2005	Hiland Partners LP	491	598	1992	Santa Fe Energy Trust	199	199
2005	Global Partners L.P.	250	434	1993	Eastern American Natural Gas Trust	165	164
2005	Transmontaigne Energy Partners	231	275	1993	Williams Coal Seam Gas Royalty Trust	128	128
<b>Propanes</b>				1979	Mesa Royalty Trust	94	91
1995	AmeriGas Partners, L.P.	\$1,875	\$2,757	1993	Torch Energy Royalty Trust	63	63
1994	Ferrellgas Partners, L.P.	1,414	2,398	1983	LL&E Royalty Trust	60	59
2001	Inergy L.P.	1,633	2,218	1978	Marine Petroleum Trust	50	48
1996	Suburban Propane Partners, L.P.	1,157	1,667				

Note: Market capitalization and firm value as of November 3, 2006; market capitalization accounts for GP promote.

Ironically, the proposed new tax legislation will seriously curtail Canada's energy trust sector, if implemented, just as the U.S. expands its own entities in the comparable structure. These entities generally had a lower cost of capital than Canadian energy trusts before the government's October 31st announcement. The cost of capital disparity between U.S. FTEs and Canadian trusts has widened significantly since the announcement which could result in increasing foreign ownership and control of Canada's energy resources and infrastructure in the future.

## Real Estate Investment Trusts ("REITs")

In the Tax Fairness Plan, the government exempted REITs, recognizing their important role in the economy. The following parallels exist between REITs and energy trusts:

- Both have a 20-year history of value creation in Canada;
- Both compete internationally for capital;
- Both were exempted from U.S. legislation designed to curtail the growth of U.S. FTEs;
- Both have proven to be a useful model for managing assets efficiently rather than solely for tax purposes; and

- Both have similar investment vehicles available to investors in other jurisdictions.

Given these similarities, we see no reason why both the REITs and the energy trust sector should not be exempted from the government's tax changes.

## Conclusions

Canadian energy trusts are an integral component of the Canadian oil and gas industry with a twenty year history of operations in the WCSB and a significant investment vehicle for Canadians in all provinces. The government's proposed change in the tax treatment of energy trusts effective January 1, 2011 will effectively abolish this sector despite:

- No firm evidence that tax leakage is occurring from the energy trusts;
- Strong evidence that government tax revenues are being enhanced by energy trusts;
- Irrefutable evidence that the energy trust sector has demonstrated enhanced productivity when managing mature assets;
- A more suitable business model for the mid-cap sector of a rapidly maturing sedimentary basin;
- Repatriation of \$10 billion in previously foreign controlled assets by the trust sector;
- Competition in a continental industry modeled after Canadian energy trusts which have already acquired Canadian assets;
- Providing access to western Canadian resource revenue to individuals and governments across Canada; and
- Trusts being the primary entities looking to materially reduce Canada's GHG emissions through CO<sub>2</sub> enhanced oil recovery and sequestration projects.

**Energy trusts are different from other trusts by virtue of their very high reinvestment requirements and their role in maintaining Canadian oil and gas production. The proposed changes will have many unintended effects, including the diminution of Canada's energy supply.**

**Exempting energy trusts from the proposed tax changes is the only sensible course of action for this government. Failure to do so will be counter-productive to the government's own stated reasons for acting.**

### Restrictions on expansion of existing trusts

On December 15th 2006, the Department of Finance provided further guidance on "normal growth" in respect of the tax measures announced on October 31, 2006 regarding income trusts and other flow-through entities essentially limiting their growth during the four-year transition period to 100 percent of their market capitalization on October 31, 2006.

By their nature, the oil and gas producing assets owned by Energy Trusts are depleting assets, requiring energy trusts to constantly replenish production, largely through corporate and asset acquisitions completed in the ordinary course of business. Just to "stand still", many trusts need to replace upwards of

25 per cent of their production on an annual basis. As a result, restrictive limitations on the ability of energy trusts to complete acquisitions will have the effect of accelerating the inevitable decline of the energy trusts.

Based on the information and analysis provided herein, we have shown conclusively that the energy trust structure enhances the ultimate recovery of oil and gas from Canada's finite resource base. Generally speaking the capital and acquisition markets have been the determining factor with respect to individual trust growth. This is efficient and should continue. Normal growth should be restricted only by the markets as assets in the WCSB continue to mature and sustainability as a prudent business strategy overrides growth.

Not only do we believe that existing energy trusts should be excluded from the Proposals presented on October 31<sup>st</sup>, but also conversions by the energy industry should be allowed to continue. This provides for a level playing field for corporations and trusts as corporations that evolve to having all or portions of their business comprising assets and a corresponding optimal management philosophy that are well suited to the trust structure.

## List of Appendices

### **Appendix A**

*October 31, 2006 Statement by the Honourable Jim Flaherty, Minister of Finance, announcing “Tax Fairness Plan for Canadians” and related “Backgrounder”*

### **Appendix B**

*“Income Trusts and Tax Leakage: Is There a Problem?”  
Yves L. Fortin, November 2006*

### **Appendix C**

*“The Inconvenient Truth About Trusts” - Gord Tait, December 5, 2006  
Publication*

### **Appendix D**

*“A Perspective on Trusts and Taxes” - Gord Tait, September 2005*

### **Appendix E**

*“Market Capitalization of Oil and Gas Producers” - BMO Capital Markets,  
November 9, 2006*

### **Appendix F**

*Presentation by ARC Energy Trust to Petroleum Technology Association of Canada conference on CO<sub>2</sub> capture and sequestration.*

### **Appendix G**

*PricewaterhouseCoopers Survey on Productivity*

### **Appendix H**

*Taxation Process for Trust Income*

### **Appendix I**

*Comparative Tax Calculations – Trusts versus Corporations*