

Income Trusts and Canada's Energy Sovereignty Past, Present and Future

The following is a look at the impact of income trusts (royalty trusts) on Canada's energy sector from the vantage point of the past, the present and the future. The purpose of this review is not to argue that the energy sector receive special exemption per se like REITs, to the exception of business trusts. Our association's position on Income Trusts calls for the repudiation of the Tax Fairness Plan in the name of fairness and good governance. As such, all existing income trusts should be fully grandfathered and free of growth constraints. Measures should be taken for a transition period to protect these companies from the takeover frenzy that this policy has induced. Future conversions should be the subject of further study and policy evaluation involving stakeholder input through public consultation.

Tax Leakage:

No discussion about income trusts can begin without first discussing the claim that income trusts result in a loss of tax revenue, or so-called tax leakage. The notion that income trusts cause tax leakage has taken on urban legend status. The inconvenient truth is that income trusts do not cause tax leakage, in fact the reverse is true. The highly guarded and secretive analysis that Finance performed that underlies its assertion of tax leakage fails to acknowledge ANY of the taxes paid by the 38% of income trusts that are (according to them) held in RRSPs and retirement accounts. To quote Jack Mintz: "Finance was wrong to treat the impact of [pension and RRSP accounts] as ZERO." Proper inclusion of these taxes would result in tax neutrality. In any event, these theoretical analyses are only as good as their assumptions, data and methodology. Clearly Finance uses the wrong methodology. A more definitive and unassailable analysis can be had by simply looking at the real world. BMO Capital Markets performed such a real world exercise by looking at all 126 companies that converted to income trusts in the period since 2001. Here are the summary results:

Average Taxes Paid Before Conversion to Income Trust: \$3.3 million x 126 companies	=	\$415.8 million per year
Average Taxes Paid After Conversion to Income Trust: \$6.1 million x 126 companies	=	\$768.6 million per year (excluding deferred taxes)
Average Taxes Paid After Conversion to Income Trust: \$9.8 million x 126 companies	=	\$1,234 billion per year (including deferred taxes)

Therefore this comprehensive real world analysis demonstrates the vastly more effective tax generation associated with businesses formed as income trusts versus businesses formed as corporations. The tax raising effectiveness is improved by a factor of 3 times for all taxes and 1.8 times if, like Finance, one totally ignores the present value of deferred taxes. This reality is a major contributing factor to the surpluses that Canada has been reporting in recent years, that Finance considers “strange and unexplained”, in their attempts to obfuscate the inconvenient truth about income trusts.

Cost of Capital Advantage of Income Trusts

As graphically demonstrated above, income trusts do not cause tax leakage. In today's protracted low interest rate environment, Canadian retail investors prefer a business that is organized as an income trust relative to the same business structured as a corporation. There are many reasons for this, the primary one being that these investors are seeking monthly income at returns higher than those afforded through investments in life annuities, GICs, bonds or high yielding stocks. Further, these very investors are more comfortable with the management discipline associated with management having to meet monthly distribution payments to unitholders. This investor preference manifests itself in higher market valuations for income trusts. This is the market's decision. As a result of this valuation enhancement, income trusts have a competitive advantage in the form of a lower cost of capital. This is an important strategic advantage that allows income trusts to compete on a global basis, where a cost of capital advantage can be a significant competitive advantage. This cost of capital advantage has been conferred on these companies by the capital marketplace and not through any "tax loophole" as Flaherty is so fond of saying, which implies it is being subsidized by Ottawa. Saying so amounts to a patent falsehood, as the absence of tax leakage can hardly support the existence of a tax loophole. Meanwhile PricewaterhouseCoopers has concluded income trusts are efficient at investing and growing.

Income Trusts and Canada's Energy Sector: Past

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 succeeded in reversing 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 2006 acquisition of assets from ConocoPhillips pushes this total close to \$10 billion. This is made possible by income trusts' competitive cost of capital and ready access to capital markets (before Flaherty).

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. Many of these acquired assets are being aggressively optimized by Canada's energy trusts, providing additional production and reserves with minimal impact to the environment. The environment is important to all Canadians and is benefiting from the capital decisions that the low cost of capital income trusts are making, specifically with respect to CO2 sequestration also known as greenhouse gas injection. Canada's greenhouse gas (GHG) challenges are well documented. As the Western Canadian Sedimentary Basin 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 to not pursue enhanced oil recovery activities through CO2 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 CO2 sequestration initiatives. In two large fields alone, Pembina and Redwater, CO2 Enhanced Oil Recovery (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. This is a rare win-win-win situation for business, the environment and Canada's energy security. 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, the corporate model and its growth-oriented investor base are not aligned with the pursuit of CO2 EOR projects in Alberta. At the very least these projects will be delayed but more likely many may not proceed at all.

Income Trusts and Canada's Energy Sector: Present

At present 20% of Canada's oil and gas production is produced by Canada's 31 oil and gas royalty trusts, representing more than 1 million barrels of oil equivalent per day. The combined market capitalization (pre Flaherty) was almost \$100 billion. 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 16 percent of the revenue. In 2006 the energy trust sector 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 Canada's Western Sedimentary Basin and operating and administrative expenditures are expected to total almost \$6 billion annually. However the picture following Flaherty's tax is much bleaker as evidenced by drilling activity which is down by over 60% since Halloween.

Flaherty's income trust tax regime is designed to shut down income trusts. In that regard, it is certain to succeed. In doing so however, his actions have left all 250 income trusts highly vulnerable to hostile takeover. Most of this takeover activity will be foreign based and largely driven by foreign private equity investors. This takeover frenzy has already begun and will multiply in intensity once the tax is passed into law. Flaherty's misguided policy announcement has created what is known in the business as an "event driven" buying opportunity. This is where an event artificially depresses the value of a publicly traded security to a level below its true worth. Flaherty has inflicted this situation on all 250 income trusts. True value in this context means the value that a private equity fund or other investor would be willing to pay for the business. In the normal course, income trusts traded at their true value. However, Flaherty's actions have created an artificial discount, that these private equity funds are keen to exploit as they scout the world looking for such opportunities. Private equity is flush with capital and ready deployment of capital is their only major constraint. Flaherty has handed them a \$200 billion capital deployment bonanza representing \$140 million per trust of value arbitrage to be captured by foreigners. Canada's incredibly lax takeover rules just makes this task even easier and more effortless for them. The \$40 billion acquisition of BCE by U.S.-based KKR or Cerberus is a perfect case study.

Upon purchasing these vulnerable income trusts, these foreign buyers will revert them to corporate form and in doing so achieve two advantages. First as corporations they will now be free of the arbitrary growth restrictions that Flaherty imposed on the Canadian ownership of trusts as the second leg of his trust crackdown. Second these foreign investors will structure their investments in the form of debt in order to take full advantage of the corporate deductibility of interest. As such these interest payments will be made from pre tax cash flows and will flow to foreign tax jurisdictions free of any Canadian taxation. Flaherty's Budget 2007 assures foreign investors of this tax free outcome as the budget contains a foreign investor tax loophole that eliminates the 15% withholding tax previously paid by them. Overall, this strategy is known as "income stripping". The consequence of this inevitable outcome is that it will induce tax leakage. This is the ultimate irony of Flaherty's policy. The very policy that was designed to stem tax leakage which did not exist in the first place will actually induce tax leakage through the hollowing out of a growing and vibrant sector of the Canadian economy. Taken to the max, this strategy would result in a loss of the \$1.2 billion in annual taxes paid by the 126 trusts referenced above and \$6 billion per annum for all 250 trusts. \$7.5 billion if BCE and Telus are included. Prior to becoming income trusts, most of these companies were private companies and were therefore protected from this opportunistic vulture takeover that has been induced by Flaherty. The combination of Flaherty and the fact that they are public makes them highly vulnerable. Takeovers will precipitate the \$35 billion loss in Canadians life savings well before Flaherty's 4 year phase in, which is nothing more than a mirage. Making 4 years into 10 years is simply another mirage, as it will only marginally slow down the inevitable takeout of these trusts.

When Flaherty announced his income trust crackdown, he indicated that the U.S. had done so themselves in 1987. This is just another in a long list of falsehoods advanced by Flaherty. What Flaherty did not tell Canadians is that the comparable market in the US to income trusts is today a \$480 billion dynamic and growing market where the scope of eligible investors is being broadened by new U.S. regulation. A large part of this vibrant market is the Master Limited Partnership (MLP) market. \$80 billion of MLPs are oil and gas infrastructure companies. These energy infrastructure MLPs are extremely well positioned to acquire key Canadian oil and gas infrastructure assets that are held in income trusts. There are no less than 10 such Canadian infrastructure income trusts. Given the higher values at which these U.S. MLPs currently trade relative to the Canadian infrastructure income trusts, there is considerable economic incentive for them to make a hostile bid for this low hanging Canadian fruit, not to mention considerable strategic value not just to these MLPs themselves but to overall U.S. energy security as well. These infrastructure assets control a large percentage of the delivery of Canada's energy resources including ultimately, the direction, the flow rates, and the building of new pipelines.

These 10 Canadian infrastructure energy trusts with a combined market capitalization of \$12.5 billion are responsible for:

- delivery of over 1 million barrels per day of conventional oil and oil sands – 50% of Canada's oil production
- delivery of more than 0.5 million barrels per day of natural gas liquids – 70% of Canada's NGL production
- transport over 2.7 billion cubic feet of natural gas per day – 25% of Canada's gas production
- process over 6.4 billion cubic feet of natural gas per day – 63% of Canada's gas exports
- produce over 160,000 barrels of ethane per day – 66% of Canada's supply
- operate over 10 million barrels of product storage
- spent \$1.1 billion with planned expenditures of \$2.0 billion over the next three years
- acquired \$3.1 billion of assets of which \$1.0 billion was from foreign owners

Income Trusts and Canada's Energy Sector: Future

As noted above, the emergence of income trusts has resulted in a repatriation in ownership of Canada's energy sector while at the same time creating a "triple bottom line" result. Flaherty's policy will make Canada's existing energy trusts vulnerable to foreign takeover and eliminate this triple bottom line result in the process. Furthermore, much of our strategic energy infrastructure assets are likely to fall into U.S. hands. Beyond that, we are leaving other sectors of Canada's energy sector more vulnerable to foreign takeover as well. For example it was just recently announced that Western Oil Sands is putting itself "in play" and looking to maximize shareholder value. Western Oil Sands is the 20% owner and operator of the Athabasca oil sands project that produces 155,000 barrels of oil equivalent a day and is currently expanding its project. Western Oil Sands is a corporation, not a trust and has a market value of \$5.5 billion. Now that Flaherty has effectively killed the income trust market, two made-in-Canada alternative value maximization alternatives that would otherwise have been available to Western Oil Sands have been eliminated, making it more likely that it will fall into U.S. hands at prices lower than would otherwise be paid. By killing the trust market, Western Oil Sands is unable to convert itself into a trust as a value maximization/disposition strategy alternative. This conversion alternative would have led to a high level of ongoing Canadian ownership. It would have left operatorship of the Athabasca project in Canadian hands. Second, because of the restrictive growth constraints on existing trusts imposed by Flaherty, Canadian Oil Sands which is a trust, and which has been an aggressive consolidator of interests in oil sands, will not be in a position to acquire Western's 20% Athabasca interest. Canadian Oil Sands is a majority Canadian owned income trust. Given that these two value maximization alternatives have been frustrated by Flaherty's actions, there is a greater likelihood that Western Oil Sands is now easy prey for foreign takeover and at prices lower than would otherwise have to be paid. \$5.5 billion is a "price point" that almost assures this foreign owned outcome in the post Flaherty capital market world. Western Oil Sands provides a real time example of how the elimination of income trusts will cause ongoing dilution to the Canadian ownership and head office control of this important and strategic sector of the Canadian economy.

This is widely understood and acknowledged by those in the energy industry, for example this from the February 12, 2007 Barron's article concerning Canadian oil sands; "We are absolutely convinced the big players there, Suncor Energy Canadian Natural and Nexen are likely to be acquired by the big (oil) companies. It is not surprising that Suncor is now starting to show up as rumored target for BP." or this from the U.S. Oil and Gas Investor from December 2006: "Asset prices in Canada are expected to soften now as the trusts' access to lower-cost capital dissolves. This means U.S. Producers can compete for assets in the region again. Now in play, the trusts are up for grabs by traditional U.S. producers."

One has to wonder how premeditated such an outcome is in light of the fact that the The Security and Prosperity Partnership of North America agreed to between Stephen Harper, George Bush and Vicente Fox in June 2006 had identified as its top priority the North American Energy Security Initiative, whose goal is "a secure and sustainable energy supply is essential for our economic prosperity in North America". Whose prosperity? Whose security?

Other Unintended, Yet Infinitely Forseeable 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 \$35 billion, and the associated lost tax revenue;
- reduced or lost income for millions of investors, many of whom depend on this income to live and maintain a decent standard of living in retirement;
- major irreversible flight of Canadian investment capital to other markets which offer sought after income-trust-like investment attributes, such as the U.S. High Yield Market, U.S. Tax Free Municipal Bond Market and U.S. MLP market;
- loss of confidence in the integrity of the Canadian capital markets on the part of Canadian and foreign investors, and the resultant loss of foreign and domestic investment capital;
- 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.

The good news is none of this has to occur, as Flaherty's folly is a man made problem. It will only take a majority of thoughtful MPs to veto this self-inflicted economic malfeasance and to recognize that Canada's future energy and economic sovereignty is otherwise very much at stake.