# Income Trusts and the Canadian Energy Sector

Posted by Stoneleigh on November 21, 2006 - 12:26pm in The Oil Drum: Canada
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Tags: cost of capital, flow-though entities, income trusts, oil production, oil sands, oil supply, private equity buyouts, revenues, royalty trusts, tax policy [list all tags]

Finance Minster Jim Flaherty recently gave the income trust sector an unwelcome surprise. Prime Minister Harper had previously promised to "stop the Liberal attack on retirement savings and preserve income trusts by not imposing any new taxes on them", but the government underestimated the momentum towards trust conversion and was facing a very significant loss of tax revenue.

Not satisfied with merely preventing new trust conversions, Flaherty decided to impose retroactive tax measures on existing trusts. Many of these existing trusts happen to underpin conventional oil and gas production in Alberta - in fact the trust structure was initially developed to facilitate production from mature assets in the oilpatch. The proposed tax changes could therefore have a significant effect on energy production and the Alberta economy specifically. Departing Alberta Premier Ralph Klein welcomed the tax measure.

> Alberta was hurt by the trust tax loophole. We were losing hundreds of millions of dollars in revenue.

However, he and the rest of Alberta may well be far less pleased once the implications of this experiment in retroactive tax policy come home to roost.

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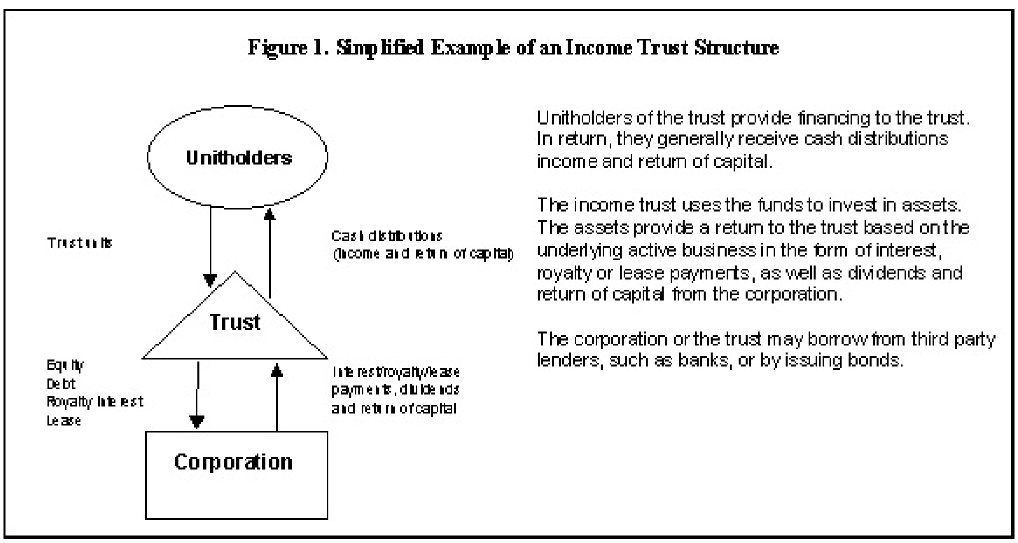
### The History of the Income Trust Structure

Income trusts, otherwise known as royalty trusts or flow-through entities (FTEs), were initiated in 1986 in order to allow large multi-national oil companies to pass mature assets, which were no longer growing in production and were producing more cash flow than could profitably be reinvested in them, on to other interests better able to focus on extracting the remaining oil and gas. By setting up a business structure allowing virtually all income to flow through to trust unit-holders on a monthly or quarterly basis, corporate taxes could be alleviated or eliminated and sufficient capital could be raised from investment to continue exploration. Canadian oil and gas trusts now produce approximately a million barrels of oil equivalent per day, or one in every five barrels of production in Western Canada.

According to Canaccord Adams (pdf warning),

> Royalty trusts are the most efficient harvesters of mature assets and, through acquisitions, provide capital to senior producers, juniors and investors to recycle into Canadian frontier exploration, development and resource plays.
>
> Since 2001, royalty trusts have raised approximately $20 billion in public markets and acquired $27 billion in oil and gas properties. Of that, 50% has been the acquisition of juniors which reinvest into exploration opportunities.
>
> For a mature industry, the royalty trust structure is not a scheme to avoid tax, but a legitimate mechanism to create value where it would either never occur or be deferred into the future.

Although initially treated as a dubious gimmick, the trusts have since become extremely popular and the idea has spread far beyond its origins in the energy sector. Much of the growth occurred in the mid-1990s and again strongly after 2000, and the consistently high yields have attracted many investors. Taxation at the level of the business has been replaced with taxation at the level of the individual unit-holders receiving the disbursements. On average, 39% of units are held by taxable Canadian investors, 22% are held by non-residents and 39% are held by tax-exempt investors. Tax exempt investment is mostly through RRSPs, although pension funds are also involved.

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### Income Trusts and the Cost of Capital

> Currently because they're paying almost all of their profits to shareholders, trusts must continuously raise additional cash to fund expansion....Although many Canadian trusts have in-house exploration and development capabilities, most grow principally by acquiring additional operating companies....Since royalty trusts distribute most of their income to unit-holders, they must raise cash to fund acquisitions either by borrowing or by selling more units.

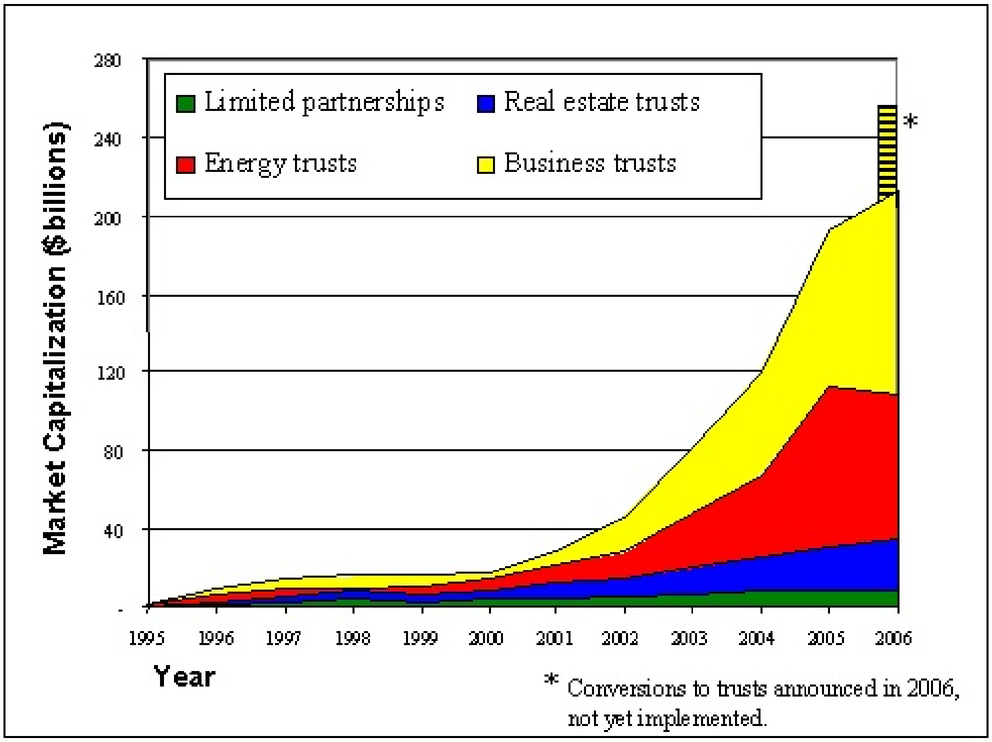
It is generally agreed that the trust structure has lowered the cost of capital for businesses which have access to it, giving relatively small Canadian businesses a competitive advantage. The vast majority of income trusts have capitalizations under a billion dollars, and without access to the low-tax trust regime capital would be prohibitively expensive. Trusts have allowed these businesses to be competitive on a global platform and to extend the commercial life of their mature assets through investment of the capital they have been able to access.

> The WCSB is a mature basin that requires a lot of low cost capital (pdf warning) to harvest. The low cost of capital environment for royalty trusts has resulted in a general increase in capital development activities by royalty trusts that has allowed the development of what would have been unexploited opportunities due to inadequate rates of return. This in turn has moderated the rise in prices for oil and natural gas by sustaining supply that would otherwise experience decline in the absence of favourably priced capital.

The competitive advantage in cost of capital bestowed by the trust structure has facilitated increased Canadian ownership in the energy industry. Until trusts became established, the dominant purchasers of energy assets were American companies with access to larger pools of capital. In recent years, however, trusts have been able to repatriate some of these assets, giving Canadians greater control over their own energy endowment and allowing them to benefit from the wealth it produces.

**Victims of Their Own Success**

The market capitalization of energy income trusts has increased dramatically in this decade as investors have increasingly sought the cash distributions they provide. From $1.3 billion in 1995, it grew to $5.8 billion by 2000 and to $41.9 billion by the end of 2004 on the back of low interest rates and high commodity prices. Income trusts as a whole increased from $18 billion in 2000 to $118.7 billion by 2004, as the popularity of the structure increased outside its initial niche in the energy market. Of the 2000 securities traded on the TSX, 255 are income trusts, up from 234 at the end of 2005. Their combined market capitalization is $210 billion, or approximately 11% of the TSE. Of the 255, 34 are oil and gas trusts and a further 21 are power and energy trusts. Three quarters of all IPOs in the last year were income trusts.

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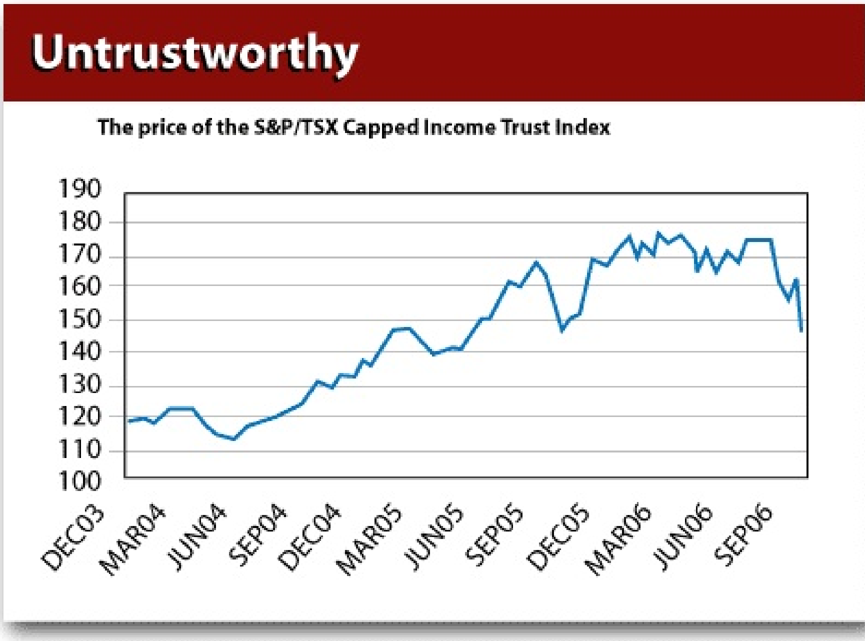
More and more companies were opting to become trusts in order to gain a competitive edge against their rivals or remain competitive as rivals converted. In 2006 almost $70 billion trust conversion announcements were made and a domino dynamic was taking root. According to Roger Conrad of the Canadian Edge investment newsletter, classic signs of froth had been appearing in the market for energy trusts in particular as a result of recent high profile oil sands hype, high oil prices and low interest rates. Along with a flood of IPOs and trust conversions, the irrationally exuberant public seemed increasingly willing to bid up trusts indiscriminately so that price increases were running ahead of dividend growth. Apparently, an increasing number of investors were of the opinion that trusts were guaranteed by the Canadian government.

Concerns have been expressed that investors may have been underestimating the risks involved in trust investments. Trusts are not corporations, which means that, in theory at least, unit-holders have unlimited liability for the actions of the trust. Trust distributions are not fixed or guaranteed and are subject to change at any time. The performance of the sector in recent years has probably led to an unwarranted degree of complacency amongst investors, especially seniors who rely on high dividend payments to fund their retirement. With the prospect of both generous dividends and capital gains, an unsustainable having-your-cake-and-eating-it-too scenario had developed. Dependency on the long-term continuation of such circumstances is a risky strategy, and indeed the trust sector had begun to experience problems in the second half of 2006, due to higher interest rates and lower commodity prices, before the tax issue came to a head.




*From: The Rude Awakening - Broken Trust*

Canadian politicians of various political allegiances have become increasingly concerned about tax avoidance. The decision to take action was finally made as BCE and Telus, with a combined market capitalization of $45 billion, announced their intentions to undertake trust conversions. According to tax expert Jack Mintz, tax revenue forfeited to the income trust structure would have risen from $500 million to $1.1 billion per year if the BCE and Telus conversions had taken place. EnCana, which made a profit of $5 billion (US) in first nine months of 2006 and was due to pay $1.5 billion in taxes, was also moving toward becoming a trust under strong pressure from its shareholders. An application had been made by EnCana to the Canadian Revenue agency for a ruling in the summer of 2005, giving the government a year to ponder the implications. The prospect of such a large a hole in tax revenues prompted Flaherty to pre-empt EnCana's trust conversion announcement by issuing his tax legislation. EnCana's plans were promptly shelved with the elimination of the competitive advantage.

### Minister Flaherty's Tax Proposals

Finance Minister Flaherty's proposals attempt to address the differential taxation of FTEs and corporations, and do so retroactively. Currently corporations are taxed at the entity level and corporate dividends are also taxable in the hands of their recipients. ('Double dipping' taxation is addressed for Canadian investors through dividend tax credits.) FTEs are not taxable at the entity level, and their distributions are only fully taxable in the hands of taxable Canadian residents. There is a lesser witholding tax on payments to foreign investors, and tax-exempt Canadian investors, of which there are many, pay no tax at all on trust distributions. The impact of trust structure on tax revenues is therefore dependent on the number of foreign and tax-exempt investors in a trust. Although Taxable Canadian investors have no tax justification for preferring to invest in trusts, both foreign investors and tax-exempt Canadians pay little or no tax on trust income in comparison with corporate dividends.

**Figure 3. Simplified Example of Taxes Paid Under a Corporate Structure**

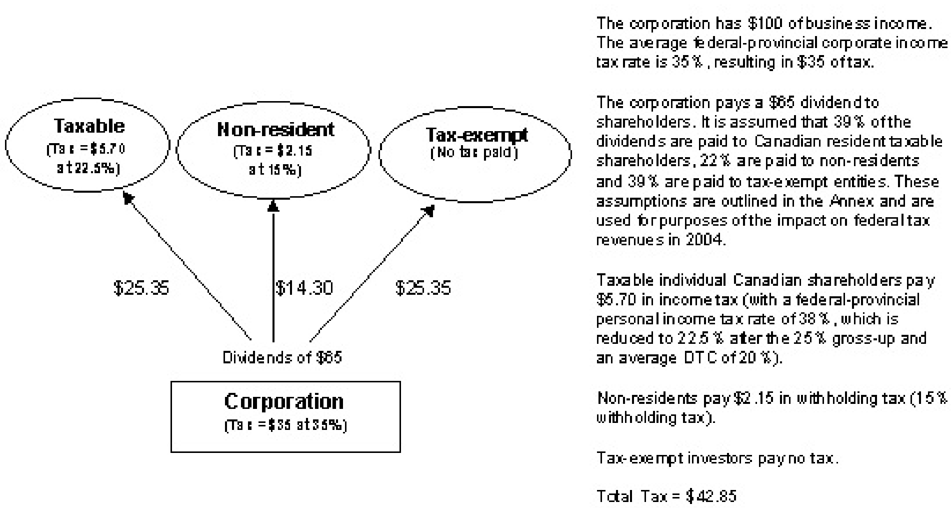



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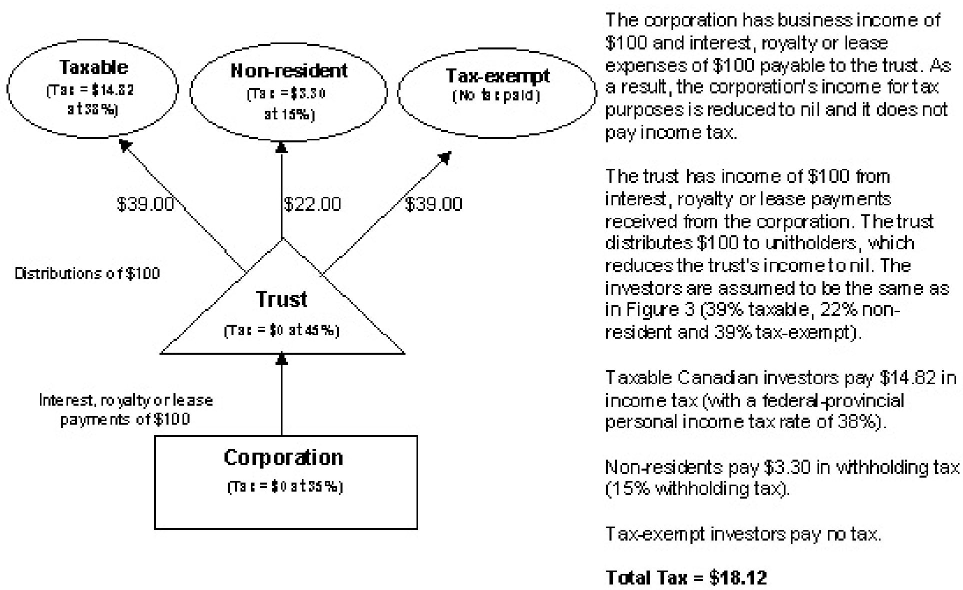
**Figure 4: Simplified Example of Taxes Paid Under a Traditional Income Trust Structure**

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Under the old system a taxable Canadian would pay 46% on either FTE income or corporate dividends, where as a foreign investor would pay 42% on corporate dividends and only a 15% withholding tax on FTE income. The effective rate tax rate on dividends paid to tax-exempt Canadian investors is 32%, while no tax is payable on FTE income. In contrast, under the proposed system the effective tax rate would be the same for FTE income and corporate dividends for all classes of investor. Taxable Canadians would pay 45.5%, foreign investors would pay 41.5% and the effective rate for tax-exempt Canadian investors would be 31.5%. New trusts would be taxed under the new system from the 2007 tax year, while existing trusts would begin to be taxed under the new system as of 2011.

Tax-exempt seniors would be significantly affected under these proposals, so Minister Flaherty has introduced an age-based tax credit and has also decided to allow income splitting for seniors as of 2007 (previously this was permitted only for Canada Pension Plan payments). These measures would reduce the impact of the tax equalization of FTE income and corporate dividends. Stephen Harper and Minister Flaherty justify their policy reversal over trust taxation by saying that what they had promised to do was to protect retirement income for seniors, not to protect the profits of large corporations and foreign investors. They argue that age-based tax credits and income splitting provide retirement income protection without allowing tax revenue losses to continue.

As the government of Stephen Harper is in a minority position, the opposition could bring down government over this policy, but if they do they would revive trust industry tax loophole and its concomitant tax revenue hemorrhaging, while doing nothing to decrease the aura of political risk now attached to the trust structure. This could well achieve the worst of both worlds and is unlikely to happen for that reason.

**Retroactive Tax Law and Political Risk**

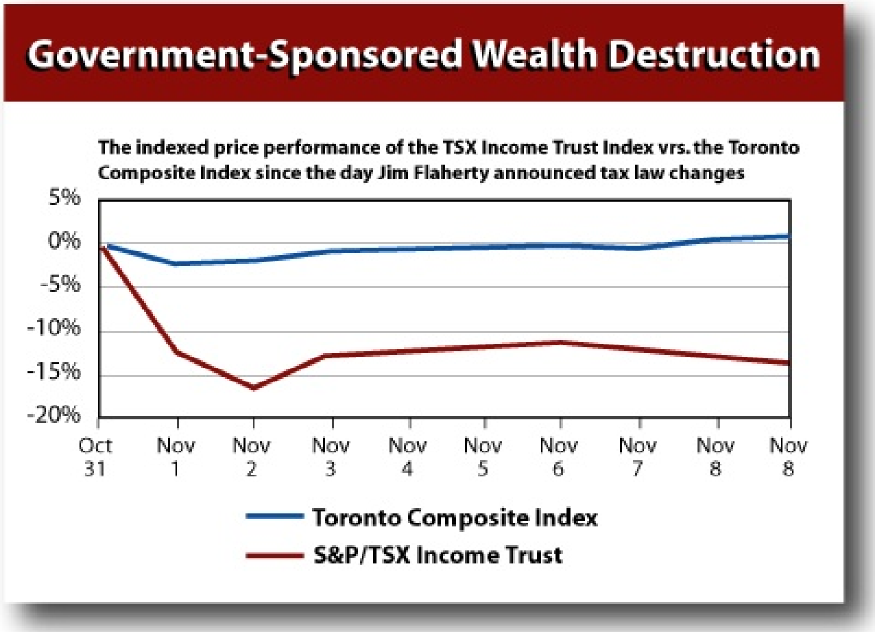
Changing rules of game in middle is a dangerous political practice prone to backfiring unpleasantly. It has the unintended, though obvious, consequence of creating a great deal of unwelcome uncertainty with regard to a wide range of business decisions - uncertainty which increases perceived risk and therefore the cost of capital. When a government breaks a very specific promise in such a definitive way, the danger of a backlash from those who had relied on the promise in good faith and made their investments accordingly is likely to be particular severe. When those investors represent the natural constituency of the part in power, the sense of betrayal is likely even worse and the party making the retroactive change is even more likely to pay a high political price.

> There were billions of dollars bet by ordinary people, companies, executives on the strength of this promise. To have this result, to have billions of dollars lopped off, seems to have struck a raw nerve.

> Canada's rationale for doing this is that they are missing out on too much revenue as the income trust sector expands. But this rationale is self-defeating; because of the message Canada's government sends with the arbitrary change: If you do business in Canada, you are liable to confiscatory changes in tax policy at government whim -- even if we promise no such changes beforehand.

*From: The Rude Awakening - Broken Trust*

Reactions from at home and abroad have been pouring in. Many Canadians are of the opinion that something had to be done to stop the loss of tax revenues, arguing that foreigners and the rich should not benefit at the expense of the masses. However, there is a significant difference between preventing any new trust conversion, which would have halted the lion's share of the revenue loss, and retroactively eliminating the advantages of existing trusts. Investors and trusts themselves are not impressed.




*From: The Rude Awakening - Barbarians at the Border*

The newly formed Coalition of Canadian Energy Trusts - a 40 member group which produces 20% of Canada's daily oil and gas production, has invested $10 billion in the energy industry in the last five years and has paid $5 billion is distributions since 2005 - is seeking a meeting with Minister Flaherty in order to argue that their industry should be grand-fathered. They intend to point out that they exploit oil and gas reserves corporations would consider uneconomical and therefore have a unique role as developers of mature properties that is under threat. Flaherty has been unequivocal that his changes will be implemented as planned.

> The opportunity costs for the country of Canada could run into the tens of billions of dollars, if not hundreds of billions. When foreign investors scout around for opportunities, for example, they do not often seek countries that enact capricious, punitive and retroactive tax laws.

*From: The Rude Awakening - Broken Trust*

### Control Over Energy Resources

The proposal to impose retroactive taxation on trusts is likely to have significant consequences in terms of control of Canadian energy resources. Energy trusts had been able to compete on a global basis, despite their relatively small size, due to the cost of capital advantage they enjoyed. Marcel Coutu, CEO of the Canadian Oil Sands Trust, is worried that his trust - with a 35% stake in the Syncrude Canada Ltd oilsands plant - is vulnerable to foreign takeover and that Canada could therefore lose control of a key national resource.

> Anything that lowers your stock price increases your takeover vulnerability, and nothing has lowered our stock price more than this event.

According to the Canaccord Adams report (pdf warning):

> If the tax proposal is enacted as presented, we believe that Canada will lose control of its energy sector and investment activity will decline in conventional oil and gas production. This tax proposal puts a 'for sale' sign on Canadian energy resources by removing a

> competitive cost of capital advantage - a wave of foreign takeovers is likely to emerge. As a result, Canadian energy decision will be made outside our borders. If ever a sector needed a responsible tax policy to foster stable domestic investment, it is the Canadian energy industry. These businesses have funded a significant percentage of total investment in Canada and that investment activity is now at risk.

Although many foreign investors may be deterred by the prospect of capricious tax law, there are others who are not, largely due to their shorter time horizon. Investors who would normally plan to stay the course and maintain mature properties need to have confidence in a stable tax regime, but private equity investors planning to strip value and flip the remains back to the public are less likely to be concerned about the long-term. These 'vulture investors' are highly unlikely to contribute to the growth and vitality of the Canadian energy sector.

> The global economy is still awash in a sea of cash and private equity firms have literally tens of billions to throw around. They are bigger, badder and hungrier than ever before. What are a private equity guy's favorite two words in the world? "Cash flow." What do Canada's income trusts have in spades? Cash flow. Put the two together and it's not hard to see: the barbarians are coming.
>
> All the Canadian energy trusts put together have a market value of $60-80 billion. That's a drop in the bucket... a mere two or three mega-deals by today's standards. The barbarians are sitting on so much investor cash that they are literally desperate to deploy it. They are no doubt drooling over the situation Flaherty created.
>
> When an energy trust goes private, for one thing, public investors no longer get to participate in the revenue stream. Instead of enriching Canadian citizens and other small-scale investors, the cash flows to bigwigs in L.A. and New York. Flaherty got brownie points for offering tax exemptions to Canadian senior citizens; those exemptions
> won't matter much if the trust distribution streams no longer exist.

Minister Flaherty's retroactive tax proposals have not only made relatively small Canadian firms vulnerable to takeover by removing their cost of capital advantage, but may also have demoralized current investors sufficiently to encourage them to sell out. Estimates of the losses suffered by the trust sector vary, but are generally agreed to be in the tens of billions of dollars. Trust takes a long time to establish and very little time to lose, and it may be a very long time before Canadian investors are prepared to trust their government again. Cashing out what remains of their wealth before anything worse can happen may begin to look like a good idea.

### Price and Supply

Even before Minister Flaherty's tax law reversal, several major energy companies had recently announced billions of dollars of cuts in their spending on exploration due to high and rapidly increasing operating costs and lower commodity prices, especially in the case of natural gas. Adding political risk and an increase in the cost of capital to that mix may well cause that trend to continue.

According to Canaccord Adams,

> An increase in the industry's cost of capital requires an increase in the required hurdle rates to justify investment in future development, thus reducing the amount being spent in the WCSB in general. In its simplest form, a 20% reduction in capital in the basin would likely erode $7 billion in annual investment (the industry investment is about $35

> billion a year) and impact annual industry oil and gas cash flow by about $3 billion in our view. This is only the beginning as other related industries such as oilfield services and other businesses will also suffer.

Analysts are not currently expecting the impact on the oilpatch to be as great as that which followed the advent of the Pierre Trudeau's National Energy Program in the early 1980s, but some are concerned about aggravating the boom and bust dynamics that have characterized the industry.

> It's going to harder for larger companies to take their mature properties and sell those to energy trusts, then take the cash for that and go do exploration," said Bill Schulz, who teaches strategic management at Calgary's Haskayne School of Business.

Reduced investment and exploration will have the effect of reducing supply over time, which would in turn cause the price of energy to rise. Conventional oil and gas supplies were already declining rapidly due to the depletion of mature fields. Continued exploration could mitigate that decline to some extent, but if investment in exploration is cut back significantly, the decline could accelerate dramatically. If trusts are subject to private equity buyouts, the effect could be far more significant due to shortening of the investment time horizon. Justice Litle of The Rude Awakening has a timely warning for Canadians regarding the implications of the recent policy change:

> Private equity firms used to take pride in shaping the companies they acquired. The old way was to really clean up a company, improve its efficiency and make a mint by way of genuine value creation. That still happens, but it's more and more rare these days. The new model is more akin to strip-mining: load the target with debt, extract as much cash as you can and flip it back to the public as quickly as possible. Under the old-fashioned way, polishing up a company took years. Not any more. The new record for a private equity strip 'n' flip is an astonishing three weeks.
>
> Private equity guys don't care about the world's energy future. The name of the game is fees and cash flow, end of story. They view their acquisitions in the same way credit card companies view subprime borrowers - as assets to be leveraged and exploited. If the barbarians can snap up these trusts like barracudas eating minnows, what do you think their focus will be? Will they be worried about growing operations, expanding capex to meet future demand? Heck no. They'll be cutting costs left and right, forgoing expenditures wherever they can. If you thought Exxon and BP were stingy on the capex side, you ain't seen nothing yet.

### The Alberta Economy - Bust Follows Boom?

The oil boom of recent years has made Alberta an engine of economic growth envied by its provincial peers. The province is debt-free, has produced enormous budget surpluses and sends its citizens prosperity cheques. However, the resource revenue that has fueled government spending has been declining as reserves of conventional oil and gas have been depleting. The province receives royalties of up to 40% on exploitation of these resources - revenue that was already threatened by depletion and announcements of drilling cutbacks, and will be further impacted by the fallout from the trust taxation decision.

The oil sands developments, which are expected to account for 90% of Alberta's output within ten years, fall under a very different royalty regime. In order to increase production from unconventional source, the provincial government of Ralph Klein negotiated a deal in 1996 with the oil sands companies, and other producers of unconventional supplies, which allows them to pay only a 1% royalty until they have recovered their enormous capital costs. It has been observed by the provincial opposition leader that the revenues accruing to Alberta from the oil sands were less than those from lotteries. It is clear that this revenue stream will not be able to replace the diminishing returns to the province from conventional production.

Even once the capital costs of unconventional production have been covered, the royalties - set to rise to 25% of net revenues - are payable on either the raw bitumen or on the upgraded synthetic crude. Naturally, most operators choose to pay royalties on the much less valuable bitumen. There is now a considerable debate in Alberta about whether to offer incentives for companies to upgrade in the province, rather than allow exports of raw bitumen. Whatever the outcome of that debate, provincial revenues from the oilpatch are set to decline with the fortunes of the conventional oil and gas industry. The anger that is likely to flow from this circumstance will probably be focused on the federal finance minister for his attempts to stem the losses to the federal treasury, even though trouble was already on the horizon before he imposed retroactive taxation on the industry sustaining Alberta's provincial finances.