Country Risk

Summary and Recommendation

About a 20% cut in stock price for buy-recommended **Canadian Oil Sands Trust (COSWF)** and **Penn West Energy Trust (PWE)** increases their attraction as resource values while their appeal as income stocks is under attack by the Canadian federal government. Reneging on the tax promises that contributed mightily to renewed prosperity and pride in the country, the conservative minority government in Ottawa would impose an ill-considered 31.5% tax on income trusts (see, *Flash*, Canada Tax Bomb, November 1, 2006 and *Flash*, Political Opportunity, November 2). The magnitude of the market losses is already about the maximum negative impact on value presuming that 63% of cash flow would be classified as income at the trust level and taxed at the rate of 31.5% (63% times 31.5% equals 20%). The tax has not been finalized and would not begin until 2011 allowing five more years of distributions without trust level tax and plenty of time to change the economically inefficient, punitive tax on oil and gas income investors. We are committed to COSWF as a buy recommendation and a double weighting in the illustrative McDep Energy Portfolio. We are also committed to PWE as a buy recommendation, but would likely reduce the suggested weighting from double to full if we became convinced that the income tax proposals would be fully implemented in their currently proposed negative form.

Resource Value Attractive Regardless of Structure

As measured in the McDep Ratio, COSWF and PWE offer attractive fundamental value regardless of differences in normal income taxation at the corporate or individual level (see table). Now McDep Ratios are lower for COSWF and PWE than for Canadian corporations in our coverage. We make our estimate of present value, the denominator of the McDep Ratio, on a tax neutral basis because buyers of properties and investors in stocks range from tax-exempt to fully taxable.

Rank by McDep Ratio: Market Cap and Debt to Present Value

	Symbol/	*Rating*	*Price (US$/sh) 2-Nov 2006*	*Shares (mm)*	*Market Cap (US$mm)*	*Net Present Value (US$/sh)*	*Debt/ Present Value*	*McDep Ratio*
Imperial Oil Limited (30%)	IMO	H	34.23	292	10,000	37.00	0.07	0.93
Petro-Canada	PCZ	B	42.23	506	21,370	49.00	0.18	0.89
Suncor Energy	SU	B	74.90	461	34,540	95.00	0.06	0.80
Encana Corporation	ECA	B	46.69	824	38,500	65.00	0.12	0.75
Income								
Enerplus Resources Fund	ERF		42.29	123	5,200	47.00	0.11	0.91
Pengrowth Energy Trust	PGH		16.64	220	3,660	20.00	0.22	0.87
Penn West Energy Trust	PWE	B	29.80	246	7,330	39.00	0.13	0.79
Canadian Oil Sands Trust	COSWF	B	23.98	468	11,220	35.00	0.08	0.71

B = Buy, S2 = Short half unlevered position, S3 = Short quarter unlevered position, H = Hold
Present Value = Shares times Net Present Value divided by (1-Debt/Present Value).
Debt = Present Value times Debt/Present Value
McDep Ratio = **M**arket **c**ap and **De**bt to **p**resent value of oil and gas and other businesses

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The McDep Ratio for COSWF is lower than that for buy-recommended **Suncor (SU)**, a corporation concentrated on ownership of a substantially similar long-life oil sands mine and upgrader as is COSWF's Syncrude. Recent operating performance is strong with Syncrude achieving average synthetic oil volume of 348,000 barrels daily in the month of October, almost the full 350,000 barrels daily of newly expanded capacity.

The McDep Ratio for PWE is lower than for three of the four Canadian corporations in our coverage. Fundamental performance has also been good with the rise in value of the company's *in situ* oil sands exposure in addition to its carbon dioxide enhanced recovery potential.

Intense Debate Ahead

Finance Canada's motivation appears to be largely driven by the feared loss of corporate tax revenue with the accelerating formation of new trusts by companies in telecommunications, finance and other businesses. Taxes were rationalized last year to neutralize the loss of corporate tax with the gain in tax paid by Canadian individuals. The perceived problem is with non-resident investors who pay taxes on distributions to their home country government, not to Canada except for a 15% withholding tax. Those are the taxes the Canadian government feels are lost.

Finance Canada's case may be overly simplistic. Though Canadian taxpayers are theoretically indifferent between distributions from trusts versus corporations, the fact is that corporations don't make high distributions. Nor do corporations generally pay the higher nominal tax rates as there are usually ample opportunities to minimize current obligations.

Meanwhile there are strong arguments to be made that the trusts have brought economic benefits to the Canadian oil and gas industry that more than offset some tax leakage. Previously a large segment of global investors were skeptical of investing in corporations with the uncertain expectations of their investment programs. Instead investors became comfortable with investing in more predictable cash flow streams and subsequent tax-efficient distribution of that cash flow. The result was a massive flow of capital into trusts that ploughed that capital back into the industry while at the same time making high distributions.

Not incidentally, the trusts are Canadian entities rather than non-Canadian global giants. The proposed tax changes threaten a fire sale of assets by Canadian pensioners to non-Canadian investors.

The government may be poised to act within weeks. A vote in the lower house of parliament is apparently decisive on such matters. The proposal by the conservative party who would normally oppose tax increases may readily gain support from coalition or opposition parties. The proposed tax would be effective immediately for new trusts effectively discouraging their formation.

The proposed change is so important it seems unlikely that it would sail through approval without modification. There ought to be some accommodation in the proposed change in taxation in oil and gas trusts as there has been for real estate investment trusts.

Aside from trying to get changes made before or after the fact, income trust managements are likely already giving thought to the best structure in the event of tax change. Some may convert

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back to corporations and then there will be a desire to manage in a way that minimizes current taxes. Tax-efficient distributions will be difficult though a stock repurchase program might be an alternative. Individuals who needed income could sell the same proportionate number of shares and still keep their pro-rata ownership in the ongoing entity.

Rising Distribution Yields for Canadian Income Stocks

On the new lower prices, the indicated annual distribution yield rises to a median 11.3% for four Canadian income stocks. The projected next twelve months distribution yield is a median 7.5% for seven U.S. income stocks.

Kurt H. Wulff, CFA

Natural Gas and Oil Royalty Trusts
Rank by McDep Ratio: Market Cap and Debt to Present Value

	Symbol/	*Rating*	*Price ($/sh) 2-Nov 2006*	*Shares (mm)*	*Market Cap ($mm)*	*Net Present Value ($/un)*	*Debt/ Present Value*	*McDep Ratio*
U.S. Royalty Trusts								
Sabine Royalty Trust	SBR		47.30	14.6	690	45.00	-	1.05
Cross Timbers Royalty Trust	CRT		48.22	6.0	290	46.00	-	1.05
Permian Basin RT	PBT		16.25	46.6	760	16.50	-	0.98
San Juan Basin Royalty Trust	SJT	B	36.98	46.6	1,720	40.00	-	0.92
Dorchester Minerals, L.P.	DMLP		24.25	28.2	690	27.00	-	0.90
Hugoton RoyaltyTrust	HGT		26.30	40.0	1,050	34.00	-	0.77
Mesa RoyaltyTrust	MTR		51.05	1.9	100	70.00	-	0.73
Total or Median					*5,300*			*0.92*
Canadian Income Trusts (US$)								
Enerplus Resources Fund	ERF		42.29	123.0	5,200	47.00	0.11	0.91
Pengrowth Energy Trust	PGH		16.64	220.2	3,660	20.00	0.22	0.87
Penn West Energy Trust	PWE	B	29.80	246.0	7,330	39.00	0.13	0.79
Canadian Oil Sands Trust	COSWF	B	23.97	467.8	11,210	35.00	0.08	0.71
Total or Median					*27,400*		*0.12*	*0.83*

B = Buy
McDep Ratio = **M**arket **c**ap and **De**bt to **p**resent value of oil and gas and other businesses

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Natural Gas and Oil Royalty Trusts
Rank by EV/Ebitda: Enterprise Value to Earnings Before Interest, Tax, Deprec.

	Symbol/	Rating	Price ($/sh) 2-Nov 2006	Adjstd Resrvs/ Prod NTM	PV/ Ebitda NTM	EV/ Ebitda NTM	P/E NTM	Divd or Distrib NTM (%)
U.S. Royalty Trusts								
Sabine Royalty Trust	SBR		47.30		13.2	13.9	13.9	7.2
Cross Timbers Royalty Trust	CRT		48.22		13.1	13.7	13.9	7.2
Permian Basin RT	PBT		16.25		11.1	11.0	13.7	7.3
Dorchester Minerals, L.P.	DMLP		24.25		11.4	10.3	16.3	9.2
San Juan Basin Royalty Trust	SJT	B	36.98		11.0	10.2	12.6	7.9
Mesa RoyaltyTrust	MTR		51.05		12.2	8.9	11.0	9.0
Hugoton RoyaltyTrust	HGT		26.30		10.9	8.4	13.3	7.5
Median					*11.4*	*10.3*	*13.7*	*7.5*
Canadian Income Trusts (US$)								
Canadian Oil Sands Trust	COSWF	B	23.97	24.4	13.2	9.4	12.6	7.7
Enerplus Resources Fund	ERF		42.29	9.4	8.0	7.3	16.0	10.5
Penn West Energy Trust	PWE	B	29.80	8.0	8.7	6.9	12.1	12.1
Pengrowth Energy Trust	PGH		16.64	7.6	7.7	6.7	9.2	15.9
Median				*8.7*	*8.3*	*7.1*	*12.4*	*11.3*

EV = Enterprise Value = Market Cap and Debt; Ebitda = Earnings before interest, tax, depreciation and amortization; NTM = Next Twelve Months Ended September 30, 2007; P/E = Stock Price to Earnings; PV = Present Value of oil and gas and other businesses

Natural Gas and Oil Royalty Trusts
Rank by NTM Distribution Yield

	Symbol	Revenue Royalty (%)	Natural Gas/ Ebitda (%)	Dist/ Ebitda	Dist/ Equity Ebitda	NTM Distribution ($mm)	NTM Distribution ($/un)	Dist. Yield (%)
U.S. Royalty Trusts								
Cross Timbers Royalty Trust	CRT	81	70	0.98	0.98	21	3.46	7.2
Sabine Royalty Trust	SBR	100	59	1.00	1.00	50	3.40	7.2
Permian Basin RT	PBT	29	36	0.80	0.80	55	1.18	7.3
Hugoton RoyaltyTrust	HGT	-	90	0.63	0.63	79	1.97	7.5
San Juan Basin Royalty Trust	SJT	-	98	0.81	0.81	136	2.93	7.9
Mesa RoyaltyTrust	MTR	-	75	0.81	0.81	9	4.62	9.0
Dorchester Minerals, L.P.	DMLP	56	75	0.94	0.94	63	2.22	9.2
Total or Median			*75*	*0.81*	*0.81*	*400*		*7.5*
Canadian Income Trusts (US$)								
Canadian Oil Sands Trust	COSWF	-	(9)	0.64	0.70	868	1.86	7.7
Enerplus Resources Fund	ERF	-	44	0.68	0.76	548	4.45	10.5
Penn West Energy Trust	PWE	-	40	0.70	0.80	887	3.61	12.1
Pengrowth Energy Trust	PGH	-	42	0.80	1.02	584	2.65	15.9
Total or Median			*41*	*0.69*	*0.78*	*2,900*		*11.3*
Kinder Morgan Energy Partners	KMP			0.75	1.70			7.2

NTM = Next Twelve Months Ended September 30, 2007
Ebitda = Earnings before interest, tax, depreciation and amortization

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