canada.com WHERE PERSPECTIVES CONNECT

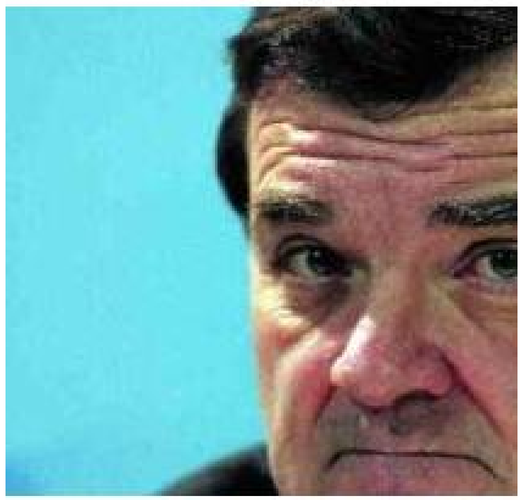
Wednesday » October 31 » 2007

The hole that Jim dug

How energy trusts are slowly being destroyed by the Finance Minister's '06 Halloween surprise

Lisa Schmidt
Calgary Herald

Sunday, October 28, 2007



CREDIT: Jean-Christophe Verhaegen, Getty Images

Since Finance Minister Jim Flaherty suddenly changed the tax treatment of income trusts last Oct. 31, the vast majority of energy trust unit prices have yet to recover.

The way Bill Andrew remembers it, the kids were just getting ready to head out for an evening of trick-or-treating when federal Finance Minister Jim Flaherty handed out a Halloween surprise of his own.

At a late-afternoon press conference in Ottawa, the finance minister shocked the country's income trust sector with plans to end its tax-favourable status.

"I think I just overheard it in the hall at work," recalls Andrew, chief executive of Penn West Energy Trust, the country's largest conventional oil and gas trust.

Immediate reactions of disbelief quickly moved to anger, he said. The move completely contradicted what the federal Conservatives promised during the election earlier that year.

"Then we just set about trying to talk to anybody . . . we basically couldn't get anywhere with the government," Andrew said.

"We provided lots of information -- there was absolutely no feedback."

One year later, Ottawa's decision to start taxing trusts still haunts the oil and gas trust sector in the form of negative returns, limited access to capital and increasing threat of foreign takeovers, industry officials say.

And even though the new distribution tax doesn't kick in until 2011, the changes have sparked some consolidation among energy trusts and a few corporate conversion attempts as trusts ponder their future under a new tax regime.

When Flaherty delivered his Halloween announcement last year, he pledged to level the playing field between trusts and corporations as he warned of growing losses to federal tax coffers amid a flurry of conversions.

The structure had been growing in popularity with investors because of its tax treatment and regular payouts, and more than $70 billion in new trusts were being proposed, including the country's biggest telecommunications companies -- Telus Corp. and Bell Canada.

The proposed changes were quickly opposed by the income-trust sector, which mounted a large campaign tapping into investor anger after the markets dropped as much as $30 billion in the days immediately after the announcement.

Royalty trusts argued that even though they pay out a large portion of cashflow to unitholders, they still raise capital and spend millions on exploration and drilling for oil and gas. They sought an exemption, or at least a longer transition period.

But all ultimately lost the battle when the legislation passed in June, starting the clock on a four-year countdown for the sector to adjust and adapt.

Nearly a year later, the vast majority of energy trust unit prices have yet to recover.

Unit prices are down an average of about 27 per cent, according to estimates by UBS Securities in Calgary. Total returns, which include distribution, are down about 16 per cent.

"Clearly prices have been eroded; now obviously the commodities are a factor and the rising Canadian dollar has had its impact on the space as well," said UBS analyst Grant Hofer.

"We can't chalk it all up to the tax announcement, but there's no doubt that we never really did climb out of the hole that we got put into right after the announcement was made."

The majority of oil and gas trusts have posted negative returns this year, particularly those producers weighted to natural-gas production. A weak outlook for prices put additional pressure on trust distributions, forcing some to cut or suspend payouts altogether.

That could spark more consolidation in the oil and gas trust sector, both friendly and hostile.

Already there's been a series of deals -- a $1-billion merger between PrimeWest Energy Trust and Shiningbank, Advantage Energy Income Fund bought Sound Energy Trust for $257 million and Penn West acquired Vault Energy Trust for $380 million.

Still, the rush of consolidation hasn't materialized as predicted by some analysts.

"We have seen some M&A activity, but not in the numbers we would have expected," FirstEnergy Capital Corp., a Calgary-based investment firm, said in a report earlier this month.

"Producers held out as long as possible, hoping for stronger natural gas prices."

The biggest deal came in September when Abu Dhabi National Energy Co. -- better known as TAQA -- announced a deal to buy Primewest for $5 billion in cash.

Foreign takeouts were one of the consequences the trust sector had warned about in the wake of the decision. For Andrew and other trust executives, the deal is a sign of things to come that will ultimately reduce Canadian ownership in the oilpatch.

"A lot of the companies that are coming in are private companies -- they are going to strip the capital, they are going to strip the revenue out and there will be precious little paid in the form of tax to anybody," he said.

"And I don't think there will be any focus of maintenance of production, or trying to build a company. I think we've been devalued to a point where the vultures are circling and they are just picking off the companies one at a time."

Long-time trust critic Diane Urquhart supported the federal government's move to start taxing trusts, which she says were "overpriced" and an investment structure that was ultimately unsustainable. But she said the changes may have opened a door that could result in less tax revenue if a change in ownership occurs.

"We don't have clear statement from the government on that," she says.

"But my solution is not to withdraw the new tax on Canadians -- it's to impose a new tax on the foreigners and pension funds who are acquiring income trusts in Canada."

Most observers expect the trust sector to evolve through mergers and acquisitions, while others contemplate moving to a U.S. master limited partnership, or MLP, similar to the Canadian trust model in terms of payouts and tax-favourable status. At the moment, however, few appear to be in a rush to convert back to a corporate model.

Fairborne Energy Trust announced last week it will fold back into a corporation as part of a deal that will see a private-equity firm inject $100 million into a new exploration and production company. But the conversion still has to be approved by shareholders in a vote expected in late December.

"There's an awful lot of opportunities that our technical folks continue to come up that we're not able to capitalize on because of the limited capital in the trust structure," said Fairborne chief executive Steven VanSickle.

"There was a lot more opportunities to grow the company and add value than there is staying a trust."

A proposal by True Energy Trust earlier this year was blocked by unitholders who opposed conversion so quickly into the four-year tax window.

But the conversions proposed to date have been by smaller players already struggling with debt levels, says Les Stelmach, an analyst with Bissett Investment Management in Calgary.

A more likely scenario post-2011 is a much smaller trust sector with some very large players that have amassing significant tax pools to allow them to carry on the payout model under new rules.

"If they can continue to shelter some of the distributions . . . it may make sense to remain in that structure," he says.

Among those Stelmach expects to survive would be Penn West, Enerplus Resources Fund and ARC Energy Trust, already among the biggest players in the sector.

"At the end of the day, the assets are going to dictate what each trust looks like," said Hofer of UBS.

Trusts with growth potential could make the transition to an exploration and production model, while more mature assets will likely evolve into a structure that includes a dividend-paying component, he said.

"I'm less and less convinced all the time it will take until 2011 for these changes to take place. Broadly speaking, investors are fairly neutral on the space right now . . . you can cripple yourself in the interim by insisting that you are a trust" said Hofer.

"I think the questions that are starting to be asked for some of these guys is if there is an opportunity or is there value in moving early."

John Dielwart, ARC chief executive, said the trust structure still makes the best business sense for mature assets in the Western Sedimentary Basin, but change in structure appears inevitable.

"As all the trusts have been doing, we've been examining our options," Dielwart told an investment conference in Montreal this week.

"Simplistically we see great benefits in maintaining the current structure as long as possible, but we certainly can't remain a trust beyond 2010 if the rules don't change."

Dielwart and other officials still hold out a faint hope the sector could still see some revisions to the new tax, but that would require a change in government and the possibility of a fall federal election has largely passed.

Nearly a year after the trust tax announcement, Andrews says he continues to field calls from investors irate over the changes. Penn West's units are trading about 25 per cent less than on Oct. 31.

The anger, he says, still runs very strong.

"Investors in particular haven't forgotten and I still get lots of correspondence, lots of phone calls of people who are very upset and have remained upset. It hasn't gone away," said Andrew.

"The comment is the same: they are waiting for an election so they can voice their displeasure in the only way they are able and that's at the ballot box."

As for his own views, he declines to talk about his future voting plans, offering a question instead.

"If somebody came in and took away a third of what you have, would you be happy?"

lschmidt@theherald.canwest.com