

## Canadian Oil Sands Trust Income Stream Denominated in Oil

Symbol		Price		Market Cap (US\$mm)	Net		McDep Ratio	EV/ Sales NTM	EV/ Ebitda NTM	P/E NTM	Distrib. NTM (%)	PV/ Ebitda NTM
		28-Jan 2004	Shares (mm)		Present Value (US\$/sh)	Debt/ Present Value						
COSWF	US\$	36.62	87	3,180	50.00	0.23	0.79	4.8	9.2	15.4	4.2	11.6
COS_u.TO	C\$	48.52										

McDep Ratio = Market cap and Debt to present value of oil and gas and other businesses

EV = Enterprise Value = Market Cap and Debt:

US\$mm 4,440

Ebitda = Earnings before interest, tax, depreciation and amortization:

US\$mm 481

NTM = Next Twelve Months Ended December 31, 2004; P/E = Stock Price to Earnings

PV = Present Value of oil and gas:

US\$mm 5,610

Net Present Value

US\$mm 4,350

### Summary and Recommendation

We continue to recommend investing in the long life income stream from Canadian Oil Sands Trust that is denominated in oil, a commodity likely to adjust in price more than the dollar declines. The volume of oil produced by the trust is expected to expand 50% in the next two years and that level can likely be sustained indefinitely. Distributions, only a third of current cash flow, may triple after the current expansion is completed in the middle of next year. About 10% of the dividend is a non-taxable return of capital and the remainder qualifies for the new, low 15% rate for U.S. taxpayers. Unit holders are equal economic partners with ExxonMobil, ConocoPhillips and PetroCanada and no general partner siphons off disguised, excessive compensation. Finally we give brief recognition to common investor concerns about operating reliability, cost of natural gas, environmental impact and legal issues of liability and non-Canadian ownership.

### Income Stream Denominated in Oil

Unitholders own a stream of oil production expected to reach about a half barrel per unit annually after mid 2005. The stream can last indefinitely, thirty years or more. Cash costs were C\$21 a barrel last year and the price received was C\$43 a barrel. At that margin the stream of oil would generate C\$11 cash per unit, US\$8 per unit. Capitalizing that stream at little more than 6 times, we match our present value of US\$50 a unit.

We discussed earlier a more thorough calculation of present value that projects revenues and costs and discounts cash flow to present value (see *Independent Stock Idea*, Canadian

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Oil Sands Trust, July 29, 2003). The current version of the calculation has higher oil prices beyond 2004 (see Table COS-1, page 6). Oil price is from the futures market. The discount rate of 9.1% per year leaves a sizeable cushion for uncertainty in any of our specific projections. In the context of ten-year inflation expectations the real return would be a high 7% per year.

The point we want to emphasize here is that the volume of oil is almost independent of the value of the dollar. Most investors are probably worried that oil may lose dollar value. We think the greater risk is that the dollar may lose oil value. If the dollar were to lose half its value in the next few years, the price of oil would likely more than make up the difference. We would further add that even the investor who believes oil will lose dollar value should own some oil because no one can be certain about either the value of oil or the value of the dollar.

### **Insurance against Oil Price Downside**

To be sure it could finance its C\$2 billion share of capital expenditures, the trust bought some insurance against lower oil price by selling forward some of its production. Some hedges were apparently instituted a few years ago when Athabasca Oil Sands Trust was merged into Canadian Oil Sands Trust. In any event, the downside is well covered with oil price fixed on almost half of expected 2004 oil volume.

A strong balance sheet further protects against oil price decline. The trust has a low ratio of debt to present value of 0.23. In addition the trust has more than a half billion dollars in unused credit lines.

### **Higher Dividend Ahead**

The current C\$2.00 per unit annual dividend is amply covered by cash flow. If the trust were to pay out 150% of equity cash flow as do popular energy income partnerships in the U.S., the dividend would be four times as much. Instead we see a double in 2006 and a triple of today's levels in 2007. The levels we foresee would continue to be covered by cash flow.

Meanwhile, the dividend is likely to remain at the current nominal level until management is confident the expansion is financed and completed successfully. The expansion to 350 mbd barrels daily capacity is expected to be complete in mid 2005. Full volumes may take a little longer to reach.

When necessary to make a choice a few years ago, the trust elected to be taxed as a corporation in its distribution of cash to U.S. taxpayers. A portion of the distribution can be claimed as a return of capital that is free of current tax obligation. The amount, about

10% in recent years, is low because the trust assets have a long life. The remainder of the distribution is taxable at the new 15% rate, we understand.

### **Operations Rebound after Unscheduled Maintenance**

The trust's sole operating asset, the 35.5% owned Syncrude plant, shipped record monthly volume of 264 mbd in December 2003. Management's budget for 2004 contemplates 235 mbd, an amount that may prove to be conservative if the plant can operate more consistently at a higher rate (see Table COS-2, page 7).

Achieving reliable operations has been a continual challenge in the remote Athabasca region. Last fall, a coker unit failed resulting in shipments by Syncrude in the month of October of 178 mbd barrels daily compared to 260 mbd in July, the last normal month (see *Meter Reader*, October 16, 2003).

Cokers operate at high temperatures as they transform thick oil into solid petroleum coke and thinner oil. The Syncrude units are similar to processing units in sophisticated refineries throughout the global oil industry. Refinery operating risk should not be too site specific and can be insured.

If there is one thing that major oil companies do well, it is running refineries. ExxonMobil, 70% owner of Imperial Oil that in turn owns 25% of Syncrude, has some of the world's most talented engineers. Exxon recently installed a new chief executive officer of Imperial who has in turn *seconded* (sent) an Imperial executive to be the new chief executive officer of Syncrude. We read into that an intensified emphasis on continuing improvement in the reliability and cost of operations.

Oil companies occasionally *second* (pronounce with the emphasis on the second syllable) executives to joint ventures. A seconded executive remains affiliated with his original company and is loaned temporarily to be an executive of a venture.

### **Natural Gas Consumption is High Value Added**

There is a long term trend for natural gas price to rise faster than oil price. In early 2004 when natural gas price rose to a particularly high premium, investors were concerned about the impact on users, including the trust.

It takes energy to make energy. Natural gas is an important cost in producing the Syncrude Sweet Blend product. Nonetheless, the amount is limited to the equivalent of 10% of oil produced and is not likely to exceed 15% of revenue for any sustained period. Actual gas cost peaked at 11% of oil revenue for Syncrude in the second quarter of 2003. It is now under 10%. In a spectacular market for gas relative to oil it might get to 15% in some future quarter temporarily.

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On the surface it seems contradictory to burn clean natural gas to produce less clean oil. Syncrude consumes an amount of natural gas equivalent to 10% of the heating value of its product, Syncrude Sweet Blend. We asked management if the plant could not just burn 10% of its output to replace natural gas.

We learned that about two thirds of the natural gas consumed is used as a raw material rather than simply as a fuel. Natural gas molecules react chemically to transfer hydrogen to oil molecules. As a result the heavier molecules from oil sand become smaller, lighter, oil molecules with more hydrogen.

Natural gas as an economic source of hydrogen cannot simply be replaced by another fuel. We were intrigued to hear that Syncrude has studied the use of byproduct refinery coke as fuel in a synthesis that draws hydrogen from water. We suppose that would use the famous Fischer-Tropsch process that Germany used to make gasoline from coal in World War II. Of course, that alternative would be quite expensive.

The high value of natural gas as a raw material means that Syncrude is likely to continue using natural gas even if the price is higher. In fact Syncrude would likely readily outbid users of natural gas who could substitute another fuel.

### **Environmental Risk is Relative**

We all favor a clean environment and we all want energy to support our lifestyle. Since there are environmental consequences to every fuel source, we necessarily make tradeoffs. Meanwhile most of our energy comes from the three fossil fuels, natural gas, oil and coal. The negative consequences generally increase with the density of the fuel. Natural gas is cleaner than oil and oil is cleaner than coal.

Moreover oils sands starts at the heavy end of the oil spectrum. Nonetheless, oil sands are cleaner than coal, typically. As long as the world consumes copious quantities of coal, oil sands have only a relative environmental drawback.

Canada has recently been through a debate on the Kyoto protocol that would limit carbon dioxide emissions. Kyoto became an important issue for oil sands as Canada ratified the treaty while the U.S. has not. The agreement would require spending to reduce emissions from lower emitting fuels like natural gas and oil while exempting emissions from coal in large swaths of the world. Fortunately a political accommodation has been reached for an optimal reduction in emissions that would not be excessively costly to oil sands producers.

Another potential pollutant, sulfur, is increasingly present in fossil fuel as density increases. Because sulfur removed from oil sands has no market in Northern Alberta, the yellow stuff is stored nearby. A recent *Wall Street Journal* account called attention to

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large above ground accumulations of the chemical element in Alberta and elsewhere. The good part about oil sands is that sulfur is mostly removed at the source rather than being emitted to the atmosphere in populated areas. It should be relatively simple to store the material safely if there is no alternative use.

The Syncrude oil sands project combines a mine and an oil refinery. The mining process digs up the sands and separates the oil from the sand. It leaves behind tailings that may include concentrations of substances that could be harmful if released irresponsibly. The mine has a large settling pond where the solids drop out of the water before the water is reused. Mining is not pretty, but it is a large global industry of which Syncrude is a small part, albeit with some of the largest equipment. Responsible operators minimize damage and we expect Syncrude to be among the most responsible.

We would have everyone spend more on mitigating environmental degradation and have that cost reflected in the price of fuel. It won't happen overnight, but the world is probably going in that direction. The trend should make natural gas and oil production and processing more profitable.

### **Legal Issues Moving to Resolution**

Resolution of some issues of government regulation may broaden the appeal of the trust units. First, there seems to be a question among Canadian institutions whether unitholders have their liability limited to their investment. An effort to correct that legal technicality apparently stalled in Ontario, but may be proceeding in Alberta. Action in either province could make the question moot in perhaps a year.

Clearing up the liability concern may open the way for the trust to be included in a major Canadian stock index. On the basis of size, the trust would normally have been added to the Toronto stock exchange index years ago. In that case, funds that invest in the index would presumably buy Canadian Oil Sands stock.

Second, there is confusion as to what, if anything, Canada would do if more than half the trust units were owned by U.S. investors. Currently about 38% of the trust is owned by non-Canadian residents. The Canadian government does not seem too concerned from a revenue point of view. Canadian holders get favored tax treatment already while taxable U.S. holders pay a withholding tax to Canada. The resolution of the issue is likely to be forced by other trusts that are at or near the limit of U.S. investors.

Kurt H. Wulff, CFA

**Table COS-1**  
**Canadian Oil Sands Trust**

**Present Value**  
 (Canadian dollars)

Volume Decline (%/yr):	0	Price Escalation Post 2009 (%/yr):	2.3
Currency (US\$/C\$)	0.76	Discount rate (%/yr):	9.1
Royalty/Profit (%):	25	U.S. TIPS Inflation (%/yr):	2.3
Fixed Operating Cost (\$mm):	300	U.S. 10 Year Yield (%/yr):	4.1
Variable Operating Cost (%):	21	Beginning Debt (\$mm):	1660
PV/Volume (\$/bbl):	5.56	Present Value (US\$/unit):	<b>50.00</b>

Year	Basic (mmb)	Volume Enhanced (mmb)	Total (mmb)	Price (\$/bbl)	Revenue (\$mm)	Oper Cost (\$mm)	Royalty (\$mm)	Capital Exp. (\$mm)	Cash Flow (\$mm)	Disc Factor	Present Value (\$mm)
Total 2004 through 2033; years ending on 6/30											
	916	421	1334	46.04	61410	21906	7220		28544	0.26	7411
2004	30.5	0.0	30.5	42.04	1284	579	13	800	-109	0.96	-104
2005	30.5	7.4	35.0	38.04	1331	580	13	400	339	0.88	297
2006	30.5	14.8	45.3	36.50	1654	647	169	150	688	0.80	553
2007	30.5	14.8	45.3	36.03	1632	643	165	150	675	0.74	498
2008	30.5	14.8	45.3	35.92	1627	642	164	150	672	0.68	454
2009	30.5	14.8	45.3	35.92	1627	642	164	150	672	0.62	416
2010	30.5	14.8	45.3	36.73	1664	649	171	150	694	0.57	394
2011	30.5	14.8	45.3	37.56	1701	657	178	150	716	0.52	373
2012	30.5	14.8	45.3	38.41	1740	665	186	150	739	0.48	352
2013	30.5	14.8	45.3	39.28	1779	674	194	150	762	0.44	333
2014	30.5	14.8	45.3	40.16	1819	682	202	150	786	0.40	315
2015	30.5	14.8	45.3	41.07	1861	691	210	150	810	0.37	298
2016	30.5	14.8	45.3	42.00	1903	700	218	150	835	0.34	281
2017	30.5	14.8	45.3	42.95	1946	709	226	150	861	0.31	266
2018	30.5	14.8	45.3	43.92	1990	718	235	150	887	0.28	251
2019	30.5	14.8	45.3	44.91	2035	727	244	150	913	0.26	237
2020	30.5	14.8	45.3	45.93	2081	737	253	150	941	0.24	223
2021	30.5	14.8	45.3	46.97	2128	747	262	150	968	0.22	211
2022	30.5	14.8	45.3	48.03	2176	757	272	150	997	0.20	199
2023	30.5	14.8	45.3	49.11	2225	767	282	150	1026	0.18	188
2024	30.5	14.8	45.3	50.22	2275	778	292	150	1056	0.17	177
2025	30.5	14.8	45.3	51.36	2326	789	302	150	1086	0.15	167
2026	30.5	14.8	45.3	52.52	2379	800	312	150	1117	0.14	157
2027	30.5	14.8	45.3	53.71	2433	811	323	150	1149	0.13	148
2028	30.5	14.8	45.3	54.92	2488	822	334	150	1182	0.12	140
2029	30.5	14.8	45.3	56.16	2544	834	345	150	1215	0.11	132
2030	30.5	14.8	45.3	57.43	2602	846	356	150	1249	0.10	124
2031	30.5	14.8	45.3	58.73	2660	859	368	150	1284	0.09	117
2032	30.5	14.8	45.3	60.05	2720	871	379	150	1320	0.08	110
2033	30.5	14.8	45.3	61.41	2782	884	392	150	1356	0.08	104

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**McDep Associates**  
**Independent Stock Idea**  
January 29, 2004

**Table COS-2**  
**Canadian Oil Sands Trust**  
**Next Twelve Months Operating and Financial Estimates**

	<i>Q1</i>	<i>Q2</i>	<i>Q3</i>	<i>Q4</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</i>	<i>Q3E</i>	<i>Q4E</i>	<i>Next Twelve Months</i>
	<i>3/31/03</i>	<i>6/30/03</i>	<i>9/30/03</i>	<i>12/30/03</i>	<i>2003</i>	<i>3/31/04</i>	<i>6/30/04</i>	<i>9/30/04</i>	<i>12/30/04</i>	<i>12/30/04</i>
<b>Volume</b>										
Syncrude (mmb)	17.0	19.2	22.4	18.8	<b>77.4</b>	21.4	21.4	21.6	21.6	<b>86.0</b>
Syncrude (mbd)	189	211	243	204	<b>212</b>	235	235	235	235	<b>235</b>
Days	90	91	92	92	<b>365</b>	91	91	92	92	<b>366</b>
Trust share (%)	24.8	30.7	35.5	33.8	<b>31.5</b>	35.5	35.5	35.5	35.5	<b>35.5</b>
Trust Oil (mmb)	4.21	5.89	7.93	6.35	<b>24.4</b>	7.59	7.59	7.68	7.68	<b>30.5</b>
Trust Oil (mbd)	46.8	64.8	86.2	69.0	<b>66.8</b>	83.4	83.4	83.4	83.4	<b>83.4</b>
<b>Price</b>										
WTI Cushing (US\$/bbl)	34.03	29.07	30.22	31.19	<b>31.13</b>	34.49	33.01	31.44	30.44	<b>32.35</b>
Currency (US\$/C\$)	0.66	0.72	0.73	0.76	<b>0.71</b>	0.76	0.76	0.76	0.76	<b>0.76</b>
WTI Cushing (C\$/bbl)	51.40	40.38	41.68	41.04	<b>43.62</b>	45.32	43.39	41.32	40.01	<b>42.51</b>
Differential	0.94	1.58	(0.58)	(0.45)	<b>(0.51)</b>	(0.49)	(0.47)	(0.45)	(0.43)	<b>(0.47)</b>
Trust Oil Price (C\$/bbl)	52.34	41.95	41.10	40.59	<b>43.11</b>	44.83	42.92	40.87	39.57	<b>42.04</b>
Henry Hub Nat Gas (US\$/m)	6.38	5.63	4.87	5.08	<b>5.49</b>	5.86	5.26	5.25	5.45	<b>5.46</b>
Henry Hub Nat Gas (C\$/mn)	9.63	7.82	6.72	6.68	<b>7.69</b>	7.71	6.91	6.90	7.16	<b>7.17</b>
AECO Natural Gas (C\$/GJ)	7.51	6.54	5.83	5.27	<b>6.29</b>	6.08	5.45	5.44	5.65	<b>5.65</b>
<b>Revenue (\$mm)</b>										
Oil	220	247	326	258	<b>1,051</b>	340	326	314	304	<b>1,284</b>
Transportation & Marketing	(3)	(3)	(5)	(12)	<b>(23)</b>	(16)	(15)	(14)	(14)	<b>(59)</b>
Other	1	2	1	0	<b>4</b>	-	-	-	-	<b>-</b>
Total	219	246	322	246	<b>1,032</b>	325	311	299	290	<b>1,225</b>
<b>Expense</b>										
Production	80	115	100	118	<b>412</b>	108	108	109	109	<b>434</b>
Purchased Energy	22	27	26	27	<b>102</b>	31	28	28	29	<b>116</b>
Crown Royalties	2	3	5	3	<b>12</b>	3	3	3	3	<b>13</b>
Insurance	2	3	1	2	<b>7</b>	3	3	3	3	<b>10</b>
Administration	2	1	2	5	<b>9</b>	3	3	3	3	<b>10</b>
Taxes and Other	1	1	2	3	<b>7</b>	2	2	2	2	<b>9</b>
Total	108	150	135	157	<b>550</b>	150	146	147	148	<b>592</b>
<b>Ebitda</b>										
Deprec., Deplet., & Amort.	14	23	31	27	<b>95</b>	30	30	31	31	<b>122</b>
Oil Hedging	40	12	22	26	<b>100</b>	38	31	24	19	<b>111</b>
Currency Hedging	1	(1)	(1)	(3)	<b>(4)</b>	(4)	(4)	(4)	(4)	<b>(16)</b>
Non-Production	6	10	11	12	<b>38</b>	13	13	13	13	<b>50</b>
Exchange on U.S. Debt	(44)	(41)	(13)	(38)	<b>(136)</b>	-	-	-	-	<b>-</b>
Future Income Tax	(2)	13	13	13	<b>37</b>	-	-	-	-	<b>-</b>
<b>Ebit</b>	<b>97</b>	<b>80</b>	<b>123</b>	<b>52</b>	<b>351</b>	<b>99</b>	<b>95</b>	<b>89</b>	<b>83</b>	<b>366</b>
Interest	13	17	21	21	<b>72</b>	23	23	23	23	<b>91</b>
<b>Net Income (\$mm)</b>										
Per Unit (\$)	1.24	0.79	1.22	0.65	<b>3.90</b>	0.87	0.82	0.75	0.68	<b>3.12</b>
<b>Units (millions)</b>										
Production (\$/bbl)	18.99	19.52	12.55	18.59	<b>16.92</b>	14.23	14.23	14.23	14.23	<b>14.23</b>
Purchased Energy (\$/bbl)	5.22	4.53	3.32	4.25	<b>4.18</b>	4.10	3.68	3.63	3.77	<b>3.79</b>
Prod&Purch En (\$/bbl)	24.21	24.05	15.86	22.85	<b>21.10</b>	18.33	17.90	17.86	17.99	<b>18.02</b>
Crown Royalties & Taxes	1%	1%	1%	1%	<b>1%</b>	1%	1%	1%	1%	<b>1%</b>
Other Expense (\$/bbl)	0.18	0.24	0.25	0.43	<b>0.28</b>	0.30	0.30	0.29	0.29	<b>0.29</b>
Ebitda Margin	51%	39%	58%	36%	<b>47%</b>	54%	53%	51%	49%	<b>52%</b>
Deprec., D, & A (\$/bbl)	3.33	3.90	3.91	4.25	<b>3.90</b>	4.00	4.00	4.00	4.00	<b>4.00</b>
Interest Rate (%/yr)	5.2	6.2	5.7	5.1						
Cash Flow (\$/unit)	1.46	0.99	1.92	0.79	<b>5.15</b>	1.74	1.61	1.46	1.33	<b>6.15</b>
Distribution	0.50	0.50	0.50	0.50	<b>2.00</b>	0.50	0.50	0.50	0.50	<b>2.00</b>

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