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Royalty review: Syncrude experience

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Canadian Oil Sands

Canadian Oil Sands overview

- Largest owner in Syncrude project with 36.74% interest
- Pure play investment opportunity in Syncrude and the oil sands
- Largest energy trust in Canada
- Market capitalization ~ $15.5 billion[1]
- Listed on the TSX with 479 million units outstanding

1. As at close on May 31/07

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Syncrude's Stage 3 expansion

- **Cost overrun of 100%**
  - Initial cost estimate = $4.1 billion (Dec '01)
  - Final cost = $8.55 billion (April '07)
  - Equivalent $85,000 / bbl per day of productive capacity
  - Current estimates in range of $100,000 / bbl per day
- **Challenges in project execution**
  - Labour productivity lower than expected
  - Shortage in engineering design and project management capacity
  - 1+ year delay in completion (production began Aug '07)
- **Increased productive capacity to 350,000 bbl/d**
  - Infrastructure in place to provide benefits for decades

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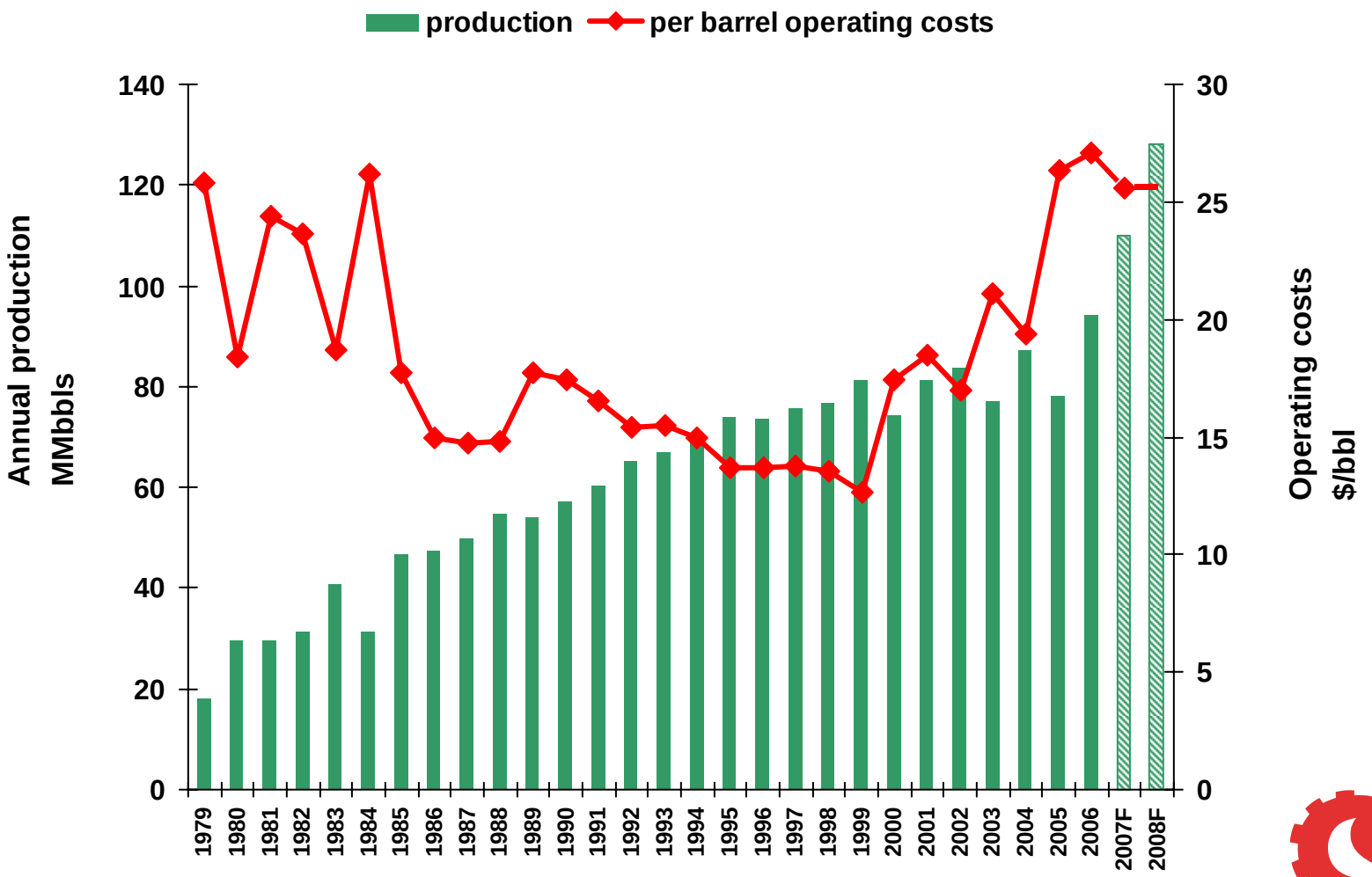
Syncrude performance



2007 based on April 25/07 Outlook; accordingly, please refer to the disclaimer on forward-looking information in Canadian Oil Sands Trust's first quarter 2007 MD&A and guidance, which are available on our website at www.cos-trust.com; 2008 based on design capacity and flat operating costs

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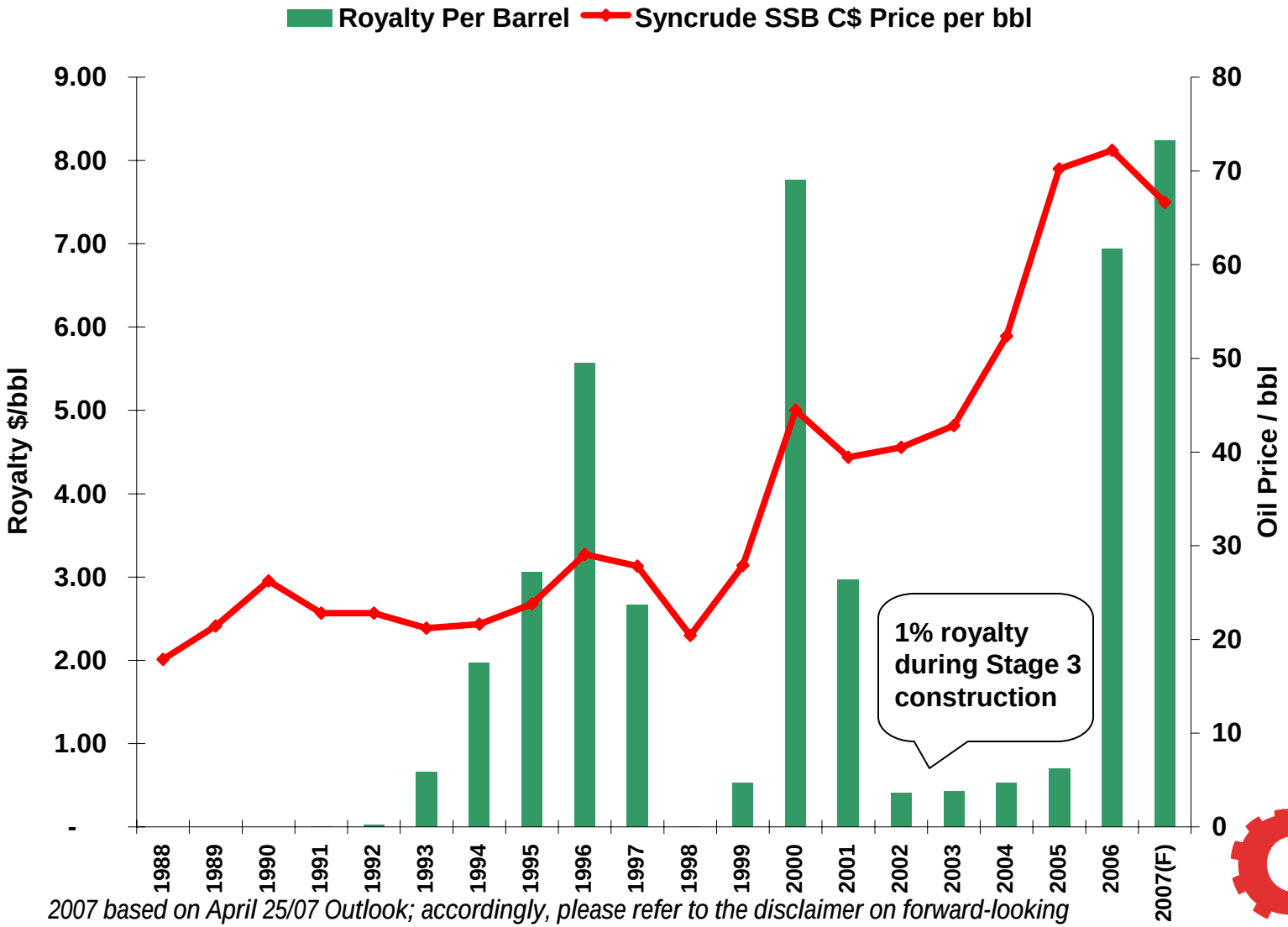
Royalties paid by Syncrude



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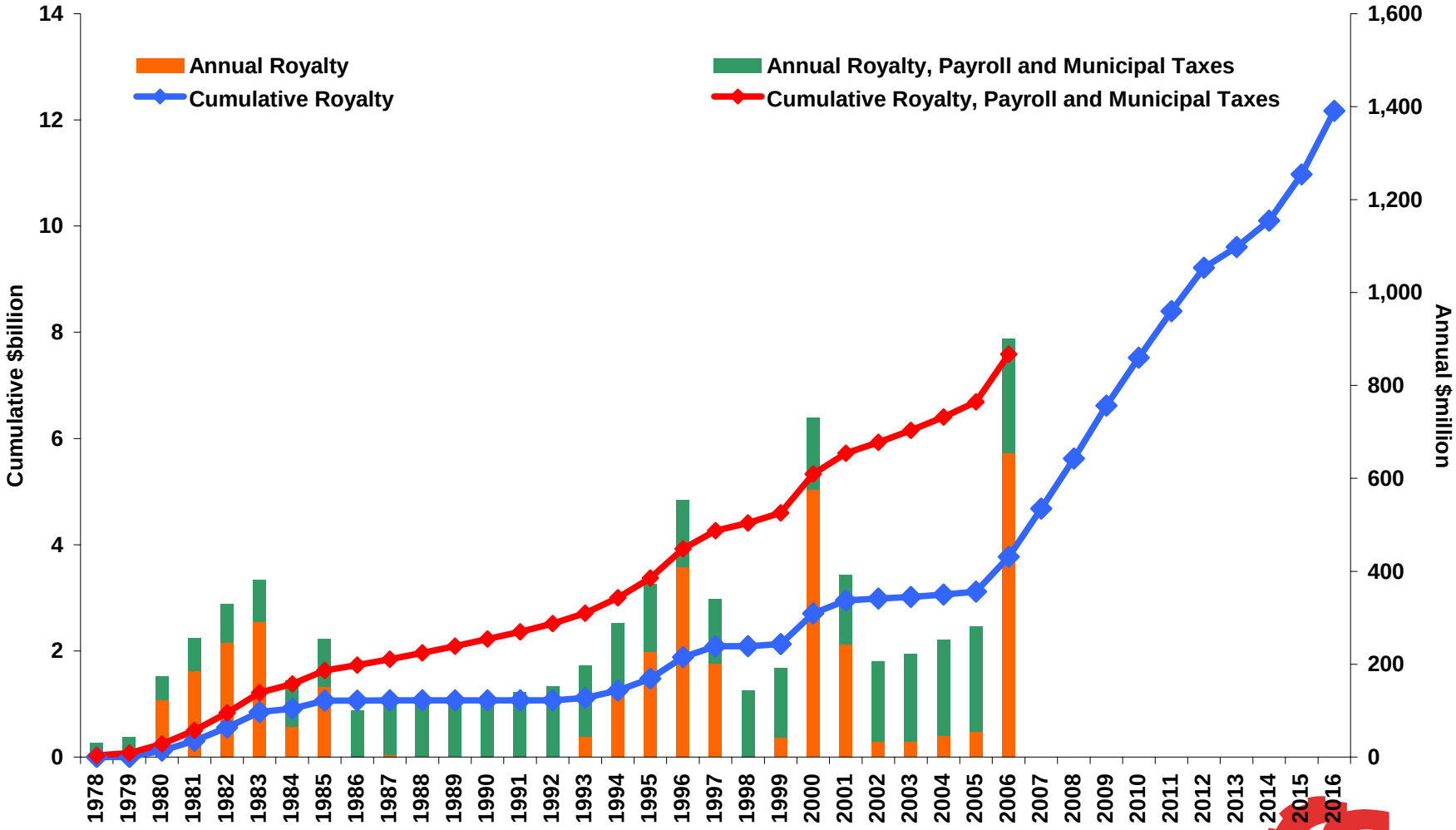
Syncrude's economic contribution

Payments to government: royalties, payroll taxes and municipal taxes and other Crown charges



2007 – 2016 based on $60/bbl WTI and Stage 3DB and Stage 4 capex with Stage 3DB onstream in 2012 and Stage 4 in 2016

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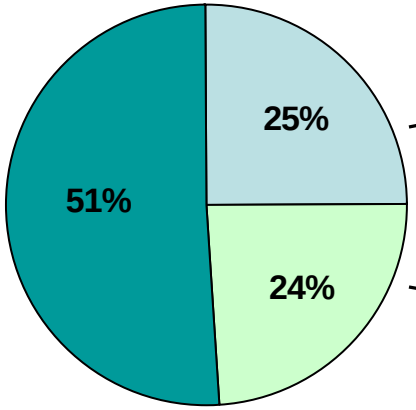
Scenarios for sharing oil sands net revenue

Current Regime

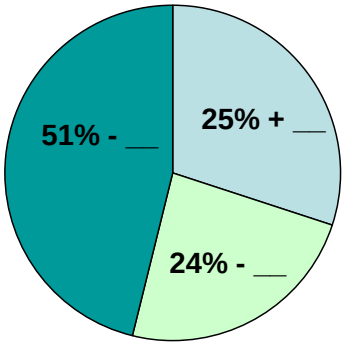
(source: CAPP 2007)



- Royalties
- Other Government Benefits
- Project Share

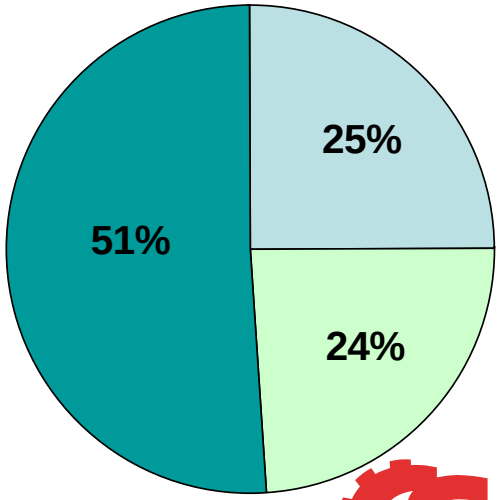
Option 1 –
Government
Increases the Royalty

threatens future investment, constricting growth as announced projects are cancelled. ***Albertans receive a bigger piece of a smaller pie.***



Option 2 –
Government
maintains the current
regime

maintains the likelihood of industry growth as announced projects continue development. ***Albertans receive their fair share of a much bigger pie.***



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Oil sands project economics

1) Cash flows – both timing and quantum are important:

• Initial capital costs	→	Have doubled in recent years
• Ongoing capital costs	→	Have doubled in recent years
• Operating costs	→	Have doubled in recent years
• Taxes	→	New Trust taxation; elimination of ACCA
• Environmental costs	→	New greenhouse gas regulations
• Project delays	→	Project execution is increasingly difficult; delays are common

2) Required rates of return – depends on perceived risks; increased risk = increased required return

Risks specific to the oil sands include:

- Long project life and lead times
- Operating cost escalation risk
- Capital cost escalation risk
- Commodity price volatility
- Project execution risk
- Resource quality uncertainty
- Environmental risk
- New technology risk
- **Regulatory risk**

Double-hit – royalty rate change impacts cash flows and risk

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Appendix

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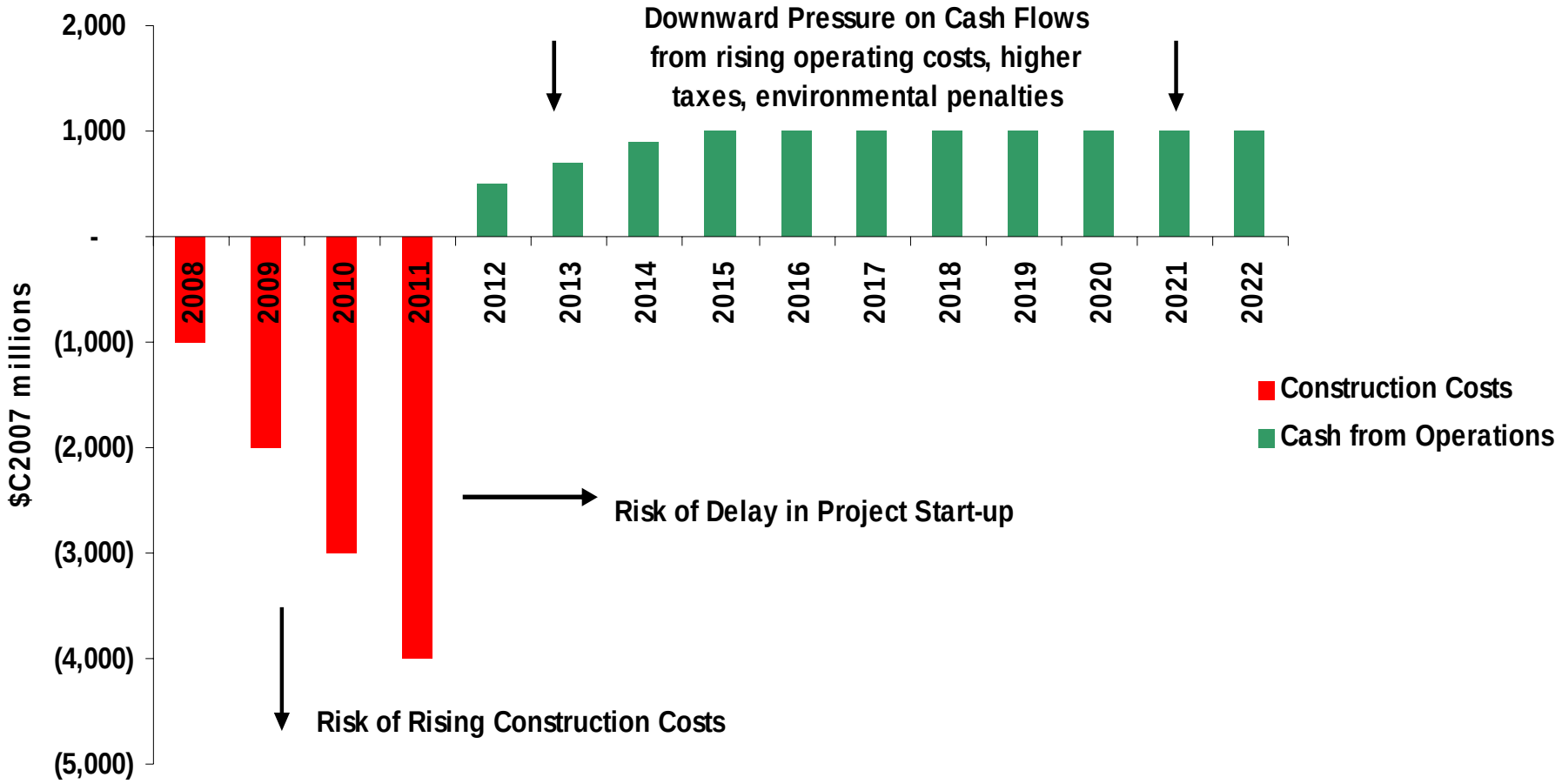
Generic mining and upgrading project economics



For illustrative purposes based on a 100,000 bbls/day mining and upgrading project at cost of $100,000/bbls/d of productive capacity and ramping up to $1 billion in cash flow annually (assuming $60/bbl crude oil price)

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Oil sands project sensitivities

CIBC World Markets published a report[1] that illustrated oil sands project sensitivities based on a generic oil sands project and the following assumptions:

- Two stages of 100,000 bbls/d each and a debottleneck expansion of 50,000 bbls/d
- Average capital expenditures of $84,000 per daily flowing barrel US$60/bbl long-term oil price
- A USD/CAD exchange rate from $0.87 to $0.90

CIBC's analysis determined that:

- A base case rate of return of 13.2%, which they categorized as 'reasonable but not excessive'
- A US$10 decrease in long-term oil prices decreased the project return to 11.2%
- A US$20 decrease in long-term oil prices decreased the project return to 8.3%
- A 10% increase in capital costs decreased the project return to 12.4%
- A 20% increase in capital costs decreased the project return to 11.5%
- A one year delay in the project decreased the project return to 12.2%
- Note that CIBC's capital cost assumption is well below current estimates, which are about 20% higher; this alone reduces expected project returns to 11.5%

Any one of these scenarios could alter investment decisions, while a combination of two or more, such as lower oil prices and higher capital costs, could destroy project economics. A change to the royalty regime may be the tipping point.

1. "Canada's Oil Sands – A Valuable Resource But Entry Costs Are High", CIBC World Markets, Jan. 22/07

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Investment community comments

"In our opinion, penalizing the shareholders of the incumbent operators is inequitable for many reasons, particularly the fact that some of these projects/expansions were undertaken in the late 1990s when crude oil prices were weak, and represented strong long-term commitments to increase oil supplies."

- Canadian Oil Sands would further add that current returns being realized by the established oil sands producers are compensation for the high risk investments made since the late 1970's

"It is true that the existing fiscal regime was introduced in a period of much lower oil prices. Realizations have increased significantly, but so have costs. Our analysis shows that the amount of economic rent may be less than it appears if the development of Canada's oil sands is a priority. Given the escalating cost environment, development could slow down if government decides to carve out a much bigger share."

Source: "Canada's Oil Sands – A Valuable Resource But Entry Costs Are High", CIBC World Markets, Jan. 22/07

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Misconceptions regarding the current royalty regime:

- Oil prices have risen dramatically yet royalty rate remains same, or royalties per barrel have declined from 1996 to 2005. This argument fails to consider:
  - The current royalty regime was not designed in response to low oil prices at the time; the rate is tied to oil prices so automatically adjusts for increases, allowing both the producer and Albertans to share in profits.
  - Impact of CAD/USD exchange rates on the US dollar denominated price of oil, which drastically lessens the realized Canadian dollar price increase.
  - Operating and capital costs have increased more than oil prices.
  - Critics have considered royalty per barrel data only up to 2005, selectively choosing a period of significant expansion during which much of the production was subject to the 1% minimum royalty; however, post 2005 many of these projects moved to the higher 25% rate, and as a result, total royalties and royalties per barrel will be significantly higher in 2007 and onward.

- Only considering royalties when analyzing whether Albertans are receiving their fair share
  - land lease payments, property taxes, and corporate and personal income taxes together with royalties illustrate the full benefits that continue for decades once an oil sands project is constructed.

- Belief that, regardless of new fiscal, regulatory or royalty burdens, investors will continue to favour Alberta's oil sands
  - investors will continue to weigh the returns and risks and will quickly move their capital in response to this evaluation.

- Belief that oil companies are the sole beneficiaries of higher oil prices while Albertans subsidize higher operating and capital costs
  - the current regime allows Albertans to share in the upside of higher oil prices with a net profits share while increases in upfront costs are borne by the company.

- Belief that oil sands should be subject to the same royalty regime as conventional oil and gas
  - oil sands projects are more like a manufacturing operation with large capital costs, long-lead times to develop, but once in production, generating revenues for decades. The current royalty regime optimizes this unique nature.

- The oil sands industry has matured and the regime should be adjusted to reflect this
  - many challenges remain: improving recoveries, reducing costs, improving environmental management, and development of new technologies for the recovery of in-situ oil sands -- the vast majority of Alberta's oil sands resource that is still in its infancy.
  - the current regime was designed with an appreciation for the full life cycle of these projects, enabling Albertans to share in profits of a mature industry.

- Critics argue that the 1% minimum royalty is a sweetheart deal and an unfair subsidy
  - the 1% minimum is only designed to allow projects to recover their capital costs and thereby reduce risk. The minimum royalty affects the timing, and therefore the present value, of royalty payments but does not impact the total royalty paid over the life of a project.

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Critique of Pembina's "Royalty Reform Solutions"

Pembina Institute's recent report "Royalty Reform Solutions" suggests that increasing the royalty from 25% to 55% of net revenue would still provide resource developers with an internal rate of return (IRR) of 15%; however, the assumptions underlying Pembina's calculations are not correct reflections of actual data or experience. Consider Pembina's model assumptions compared to Canadian Oil Sands' 2007 guidance and long-term outlook as well as current industry and economic conditions:

	Per Pembina Institute model assumptions for mining and upgrading project	**Per COS' 2007 Guidance**	**Per COS' long-term outlook provided to market**	**Recent economic/industry conditions**
CAD/US Exchange Rate	0.85	0.87		0.94
Natural gas consumption (GJ/bbl)	0.715	0.94	0.85	
Non-gas operating costs ($C2007/bbl)	12.01	18.22		
Initial capital expenditures (daily $C2007 per flowing barrel)	63,000	85,000[1]		100,000+
Maintenance capital expenditures ($C2007 per barrel)	1.25	5.56	5.00 – 6.00	

The Pembina Institute has made assumptions that are clearly different than what the Syncrude Project and other producers are experiencing. These differences, particularly with respect to operating and capital costs which Pembina greatly understates, significantly affect project economics; as a result, Pembina's estimates of project IRRs are misleading.

1. Reflects Syncrude's Stage 3 Expansion completed in 2006.

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