NATIONAL POLICY 41-201: COMMENTS

DATE: 12/7/2003

TO: CANADIAN SECURITIES ADMINISTRATORS

CC: [CLICK HERE AND TYPE NAMES]

FROM: DAVID CAREY, VICE PRESIDENT BUSINESS DEVELOPMENT, ARC ENERGY TRUST

RE: REQUEST FOR COMMENTS: NATIONAL POLICY 41-201

ARC Energy Trust supports the CSA's initiative to improve the quality of disclosure as it relates to Income Trusts and other indirect offerings. ARC shares the CSA's desire to ensure that all investors have access to sufficient information to make an informed investment decision. We are pleased to offer our comments on the proposed National Policy 41-201 as outlined below:

PART 1 – INTRODUCTION

Comments on specific questions:

1. Yes, we agree that the scope of the policy is correct.

2. The discussion with respect to indirect offerings is relatively clear although we believe it could be simplified. For example: A direct initial public offering is when an issuer uses the proceeds from an equity offering to partially fund the purchase of an interest or a royalty from an unrelated operating entity. An indirect initial public offering is when an issuer uses the proceeds from an equity offering to partially fund the purchase of an interest or a royalty from a related operating entity. We agree with the distinctions you make between the two.

3. We think the document could be improved by more completely separating the descriptive sections that help investors understand the different attributes of income trusts and the specific policies that apply to issuers and advisors. In addition we believe the clarity of Part 4 of the document could be improved by making it absolutely clear when you believe "promoters liability" and "vendors responsibilities" apply with respect to indirect offerings.

As a general comment, it might be helpful in section 1.2 to state that the entitlement to substantially all of the cash flow from the operating entity could be in the form of a royalty payment, interest payments or dividends.

PART 2 – PROSPECTUS DISCLOSURE

We agree that providing guidance on risk factor discussion is appropriate. Any factors which could lead to a change in distributions should be disclosed and highlighted for investors.

A. Distributable Cash:

We agree with your view that investors need to think of income funds as being more similar to a high yielding equity than a debt security. For clarity, Part 2.2 needs to be re-written to get across the concept that distributions that are classified as "return of capital" reduce the cost base of the units and hence are "tax deferred" as opposed to non-taxable. The last sentence should be re-written to get across the concept that the "return of capital" distributions end up being taxed as capital gains, or alternatively reduces the amount of capital loss which can be claimed on the sale of the units.

The cover page disclosure described in Part 2.4 could be misleading and is unlikely to provide investors with the information you are hoping for. For oil and gas royalty trusts, estimating the portion of the distributions (not investment) that will be taxed as a return on capital is very difficult as it will depend on a wide range of variables, not least of which are commodity prices, operating performance of the oil and gas assets and managements ability to run the business as a going concern. Forecasting these variables beyond the first 12 or at most 24 months may suggest to the investor a degree of confidence in the distributions that is not warranted. Similarly, estimating the portion of distributions (again not the overall investment) that are to be treated as return of capital can be done for the an initial 12 or 24 month period, but to forecast beyond this ignores the changes that can occur as a result of mergers, acquisitions, equity offerings or other corporate undertakings. Again referring to "return of capital" as non-taxable is misleading.

The focus on the tax definitions of "return of capital" and "return on capital" may also mislead investors, particularly those in oil and gas royalty trusts, who are trying to calculate how much of their distributions (from a declining asset base) are an economic return on their capital as opposed to the tax definition. A good example of the difference between the tax definitions and the economic definitions of return of capital can be found be examining the returns to the initial investors in the Athabasca Oil Sands Trust IPO. From a tax perspective, all of the distributions received by an Athabasca investor in the first four years they held their units were a "return of capital" and hence reduced their cost base in their units. From an economic perspective, effectively all of the distributions could be considered as a "return on capital".

B. Distributable Cash: Non-GAAP Measures

While we understand the CSA's concern about non-standard financial statements, it should be remembered that for many investors GAAP earnings statements are not well understood and unfortunately can be manipulated to provide a sense of well being. The goal should be to provide a clear explanation of the sources and uses of cash as investors need to understand how much cash is provided from the underlying operations and how that cash is used.

C. Short-Term Debt

We agree with your concern that debt obligations may cause a reduction in distributions and consequently the key terms and requirements of the debt need to be disclosed. We believe that a full discussion of the terms and their potential impact on distributions should be covered in the risk section of a prospectus and in the quarterly MD&A, however designating the credit agreements as material contracts should not be required providing adequate continuous disclosure is made on an ongoing basis in the MD&A.

In terms of evaluating risks for oil and gas royalty trusts, this may be putting too much emphasis on short-term debt at the expense of the more significant risks of these investments such as changes in commodity prices

D. Stability Ratings

We have very strong concerns about stability ratings and their apparent endorsement by the CSA. First and foremost our concern is that income trusts are equities, they are not debt instruments, and any "rating" of them by firms that are best known for their debt ratings will only serve to give the investor a false sense of security and may lead them to believe they are investing in a fixed income security.

An investment in an income trust is an investment in the assets, and hence the cash flow, underpinning the trust and in the trust's management. This is the same decision that an equity investor faces and the investment decisions should be made in much the same way that other equity investments are made. In the oil and gas sector, the research coverage of our sector, and particularly the larger and more established trusts, is very good and should provide the investor with all of the information required to make an informed investment decision.

PART 3 – CONTINUOUS DISCLOSURE

We concur with your belief that an income trust's performance and future prospects depend to a large degree on the performance and operations of the underlying operating entity. In our case, we strongly believe that our consolidated financial statements provide the necessary information for investors to understand our business and that the cost involved in having our operating entity become a reporting issuer is unwarranted and unnecessary. In addition, the internal documents such as promissory notes and royalty agreements are not material in the context of a wholly owned subsidiary.

With regards to a breakdown of distributions between "return on" and "return of" capital we already provide guidance to our unitholders on a quarterly basis as to what we expect the split to be for the current calendar year.

PART 4 – PROSPECTUS LIABILITY

We are concerned that this section does not appear to differentiate between arms length and non-arms length transactions with regards to liability and accountability of the vendor. Specifically, the last sentence of part 4.3.1 the document states that "a vendor that receives, directly or indirectly, a significant portion of the offering proceeds, is a promoter and should sign the prospectus in that capacity" and does not reference whether the vendor is related or unrelated. In the oil and gas industry we frequently issue equity to fund the acquisition of oil and gas assets from third party vendors. In these transactions, the third party is a vendor and should not be asked to take on additional liability as a promoter just because we chose to finance the acquisition through the issuance of equity as opposed to using lines of credit.

Similarly, we found the wording in Part 4.4 a little unclear with regards to whether this section is intended to apply for indirect offerings only (as defined in section 1.6 of the draft document) or whether some of it would apply to all offerings. Our view is that it should be clear that this section does not apply to arms length transactions where the proceeds are being used to fund the acquisition of assets from an unrelated third party. In the oil and gas sector we rely on a continual flow of oil and gas asset sales from industry sources to maintain and grow our business. We are concerned that if this were interpreted such that a vendor of oil and gas assets had prospectus liability if they sold to a trust, which financed the acquisition through the issuance of equity, that vendors would preferentially sell to oil and gas corporations rather than trusts.

Part 4.4 in general focuses on the need for additional disclosure in respect of the acquisition agreement and to the extent that such additional disclosure is material in the circumstance, we favour expansion of the disclosure requirements related to the terms ands conditions of the acquisition agreement and the relationship of those terms and conditions to the prospectus offering, if any. The policy considerations should apply generally to any offering where the use of proceeds relates to a "significant acquisition" which currently defines the standard for materiality. The policy should stop at the disclosure requirements. We so not think that the refusal of a receipt is warranted where the vendor is not a "promoter" and the CSA staff are of the view that the vendor is not taking appropriate responsibility (directly of indirectly) for the information provided as a basis for the offering.

PART 5 – SALES AND MARKETING MATERIALS

We agree with your concern that the use of the term "yield" may lead to some confusion on the part of investors as it is most commonly used in reference to other types of investments. This is the same concern we have with using bond rating agencies to provide an opinion on the stability of distributions from income trusts.

We are confused by the definition of "yield" used in the last paragraph in Part 5.2. We suspect that you are trying to use the economic definition of return of capital as opposed to the tax definition. If this is the case we believe this to be confusing and are not certain that it can be calculated in advance for oil and gas assets. We are concerned that your instructions may lead investors to mistake the "return of capital" for tax purposes as an economic return of their capital. The two "returns" are not necessarily the same. In the Athabasca Oil Sands example cited earlier, according to your definition of "yield", the "yield" in the first four years of its existence would have been zero.

As previously discussed, we believe your use of the term "tax-free" with regards to "return of capital" distributions to be misleading.