Canadian Oil Sands

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COMMENTS ON PROPOSED AMENDMENTS TO NATIONAL POLICY 41-201 INCOME TRUSTS AND OTHER INDIRECT OFFERINGS

This document is intended to register comments by Canadian Oil Sands Limited, the manager of Canadian Oil Sands Trust ("Canadian Oil Sands"), on proposed amendments to National Policy 41-201 Income Trusts and Other Indirect Offerings (the "Policy"). In particular, we are commenting on the proposed amendments specifically related to Distributable Cash ("DC").

Given the broad range of industries encompassed by this investment category, we believe a single prescribed calculation of DC may not be meaningful and may actually reduce the information's usefulness. We therefore support the "disclosure based" approach of the CSA proposed amendments and believe that additional MD&A disclosures, as opposed to a prescribed or specific calculation, will be more effective in helping users understand and interpret the financial information that is presented. Canadian Oil Sands is concerned that providing a single point estimate of DC will lead to undue reliance on an inherently imprecise number by unsophisticated investors.

We also strongly support an approach that focuses on historical financial information tied to an entity's GAAP financial statements. The CSA proposed disclosure guidance focuses on "the relationship between historical distributions, cash flows from operating activities, and net income (loss)". While it is important to discuss risks and uncertainties that may impact the stability or sustainability of future distributions, we have significant concerns with recommendations that support future-oriented elements in deriving a single point estimate of DC.

Canadian Oil Sands has taken an active role in discussing DC disclosure standards through participation on the Canadian Association of Income Funds ("CAIF") Distributable Cash Sub-Committee. Through this process we have communicated our views and concerns on proposed frameworks by various stakeholders. We believe some of the proposed Policy amendments are well aligned with our own views on appropriate disclosure.

The following pages provide a summary of the key disclosure elements that we support as well as those areas of concern. While this discussion includes items not specifically addressed in proposed National Policy 41-201 amendments, we believe that it is important to provide additional detail on our position. We support the fundamental principle of "providing access to sufficient information to make an informed investment decision", but we also recognize that additional disclosures must be weighed against the added cost and complexity. Furthermore, the complexity itself may create poor disclosure which does not benefit the investor. It is hoped our views will provide the context for further discussion of the alternatives available to the CSA.

DISTRIBUTABLE CASH ("DC")

In later sections of this submission, we provide specific details regarding the calculation of DC elements. This detail is in response to stakeholder proposals regarding such a calculation. Despite this analysis it is important to note that Canadian Oil Sands does <u>not</u> support a requirement to disclose a DC calculation in the MD&A.

We are concerned that investors will not understand this complex calculation, causing them to attribute unwarranted stability and sustainability to the numbers derived. This is particularly concerning in regard to the future-oriented nature of some of the DC elements which by their nature require significant assumptions and estimates.

We also believe a prescribed DC calculation implies the application of a rigid formula for each period in determining distributions. That is, a formula derives the cash to distribute and justification is required when actual distributions differ. The practical reality, however, is that a board of directors must consider a number factors in declaring a distribution, and different boards may reach different conclusions from the same information. Among other things, declaration of distributions is dependant on a variety of factors including:

- The operating entity's financial performance;
- The trust's current cycle of growth or expansion;
- The trust's leverage levels;
- The term, structure, and covenants of an entity's debt;
- The current business environment and expectations for the future;
- The current business operations and expectations for the future; and
- Risks and uncertainties that could impact the business and its environment.

It would be very difficult to incorporate all of these elements into a single DC calculation. A formula approach implies less flexibility and greater distribution certainty than is warranted. As an income trust does not have a fixed obligation to make specific distribution payments to investors, disclosure must not imply that a fixed payment will be made based on a formula.

In order to avoid these DC issues, we favour specific MD&A discussion of the factors that influence an entity's distribution decisions. The expanded disclosure of risks and uncertainties proposed in Subsection 6.5.1 of the Policy is consistent with this view.

Another shortcoming of a prescribed DC calculation is that it "arbitrarily allocates" sources of cash to specific uses, despite the fungible nature of cash. We agree with a recently quoted observation that "identifying the source of the cash used to make a distribution will often be an exercise in futility". It is not possible to determine whether cash used to make a distribution is a result of cash from operating activities or whether it is sourced from financing in the period. By its very nature, a DC calculation is an arbitrary assignment of cash uses to cash sources.

We believe that it is preferable to focus efforts on a robust discussion of the trust's sources and uses of cash as outlined in the statement of cash flows. An analysis of the combined uses of cash, such as capital expenditures, acquisitions, distributions, and debt repayments, should include an analysis of the combined financing sources including cash from operating activities and any external financing in the period. Our current MD&A disclosure does not use the term DC, but we feel our discussion of Unitholder distributions is meaningful and understandable to investors in its current format.

We believe an analysis should be based on the GAAP financial statements and supplemented with extensive discussion of known factors that may influence future sources and uses of cash. A significant increase in expected capital expenditures or debt repayments, for example, may be identified as an item that could reduce distributions in future periods unless other funding sources are available.

All of this information would be useful to investors in making informed investment decisions, and could be provided without deriving a specific DC figure on which undue reliance may be placed.

SPECIFIC COMMENTS ON THE PROPOSED 41-201 PROPOSALS
Section 2.6 - Expectations about the format of the distributable cash calculation

a) We agree that if a non-GAAP measure, such as DC, is disclosed in the MD&A that it should be reconciled to the most directly comparable GAAP measure. Under current practice this measure is cash from operating activities including changes in non-cash working capital.

It is important to note that Canadian Oil Sands believes that cash from operating activities before non-cash working capital ("funds from operations") is a more appropriate comparison, despite the fact that it is a non-GAAP measure. We believe this measure is a more accurate reflection of the cash generated from the operating activities of the business during a period. We often see significant working capital swings which can impact cash from operating activities and leave a wrong impression. In the fourth quarter of 2006, for example, Canadian Oil Sands experienced a significant working capital decrease that increased cash from operating activities, as opposed to funds from operations, by over $100 million. This resulted from a coker outage that reduced sales and thus accounts receivable at year end.

Funds from operations, which is before changes in non-cash operating working capital, provides a better indication of the cash generated by operations during the period, and thus is a better starting point for any discussions of DC. Funds from operations rather than cash from operating activities are used by many investment analysts for this very reason. If the concern is that this term is not defined under GAAP, perhaps a better solution would be to have the standard setters define it. Of course, working capital changes that are material and not the result of normal fluctuations in operations should be discussed as well.

b) With respect to capital expenditures, Canadian Oil Sands supports disclosure focusing on historic capital expenditures in the financial statements, combined with a required discussion of future expectations relative to these historic figures. We would also support separately classifying historic expenditures as maintenance versus growth.

We do not support the concept of maintenance of productive capacity due to difficulties in defining and deriving this future oriented measure. More detail on our concerns about maintenance of productive capacity is provided in subsequent sections.

c) With respect to other adjustments, we support the idea of allowing other adjustments with appropriate explanation and disclosure. More detail on our concerns in this area is also provided in subsequent sections.

Section 2.7 - Disclosure about the adjustments and assumptions underlying distributable cash

a) We are concerned about the proposal to discuss the work that was done by the issuer to ensure the completeness and reasonableness of the information. While we support a detailed discussion of the nature of the adjustments and the specific risks and uncertainties, describing the work to ensure the calculations were complete and reasonable may not be practical or provide useful information. This would be akin to describing specific internal control procedures, which would not be particularly useful in our view.

b) An additional proposal under the Policy would require an issuer to explicitly state that DC uses "supportable assumptions given management's judgement about the most probable set of economic conditions". This statement implies that management has an inherent ability to forecast economic conditions which is clearly not true and cannot be implied. As an officer of Canadian Oil Sands, I would have difficulty incorporating such a statement into our disclosures.

c) Similarly, a requirement to “disclose all factors, events or conditions that are likely to occur in the future that may impact the sustainability of future distributions” would be very difficult for any management team. In our Annual Information Form and our Annual MD&A we discuss specific risk factors impacting Canadian Oil Sands. To create additional risk disclosure specific to the sustainability of distributions and suggest it incorporates “all factors” is not practical or possible for any issuer.

d) The proposal to “describe each of the underlying assumptions used in preparing each element of the forward-looking information, including how those assumptions is supported” is clearly too detailed and impractical. The additional detail would quickly overwhelm the important MD&A discussion and reduce the usefulness of the information to the user. In addition, the extra expense in establishing controls around deriving the estimates and assumptions could be significant. This proposal raises the question whether some estimates would require outside consultants to support. The time, expense, and legal implications of this proposal would be immense.

   We are in favour of complete discussion and disclosure, but some of these proposals are clearly beyond what is practical.

Section 3.2 - Disclosure about material debt

a) We support proposals for increased disclosure of material debt obligations including terms, security, and covenants. In addition, we would support disclosure about management’s intention with respect to repayment versus refinancing of debt obligations that will mature in the next year.

Section 6.5.1 – Risks and uncertainties

a) While Canadian Oil Sands supports discussion of trends and risks, a detailed discussion “about the potential commitment to replace capital assets, including a quantitative discussion about expected annual capital maintenance expenditure levels relative to current levels” raises some concerns.

   It will be difficult for many trusts to define maintenance capital, as discussed more fully later in this letter. In addition, while we believe general estimates may be possible based on current capital expenditures and industry benchmarks for some issuers, specific detail for individual years will be difficult to provide. The level of detail, due diligence, and support required for such disclosures can quickly escalate and make this requirement impractical.

Section 6.5.2 – Discussion of distributed cash

a) As discussed earlier, we believe the concept of providing investors with “information about the sources of the distributed cash that they receive, including whether an issuer borrowed amounts to finance distributions” is an exercise in futility without an arbitrary ordering convention.

   The combined sources and uses of cash each period can be discussed in the MD&A to provide useful information to users without an arbitrary allocation of cash to specific sources and uses. Cash is fungible.

b) We believe that the proposed tabular format comprising cash distributions, cash flows from operating activities, and net income does not provide additional useful information. All of these items can easily be obtained from an issuer’s GAAP financial statements, so displaying them in a tabular format is not particularly helpful.

   As suggested earlier, if a DC calculation is required, we do support a reconciliation to cash flow from operating activities and additional MD&A discussion. This additional information would specifically include a discussion of the difference between DC and distributions in the period without requirements for detailed quantification.

OTHER CANADIAN OIL SANDS' CONCERNS

"Return of Capital" Versus "Return on Capital"

There are essentially three types of return of capital: tax, economic, and accounting. We believe disclosure of the tax return of capital is important in determining the after-tax return of an investment. We do not support disclosing or discussing economic or accounting return of capital. We believe the complexity involved in explaining these concepts would result in a discussion that is not meaningful or useful to investors in making their decisions.

Detailed calculations of economic return of capital require significant assumptions regarding the segregation of cash, the classification of items such as capital expenditures, and potential calculations of long-term funding requirements for items such as pensions and asset retirement obligations. As explained earlier, cash is fungible and assigning the sources of cash to specific uses requires arbitrary allocations. More importantly, classification of capital expenditures as growth versus sustaining requires significant assumptions that may not be consistently applied across entities. Also, deriving a deduction for items, such as pension, which may be different than the expense amount or funding is also problematic.

The return on capital concept is inherently forward looking, complex, and subject to assumptions that reduce its usefulness.

Historical Versus Forward-Looking Estimates

There are some key limitations of an accounting-based estimate of DC. Depreciation is often not an appropriate proxy for the capital required to sustain the business assets, and net income includes estimates and non-cash items, such as pension expense and asset retirement accretion, that may not be indicative of required cash outlays.

To address some of these shortcomings new and complex concepts, such as the capital required to sustain the productive capacity of the business and economic return of capital, are being proposed. These proposed disclosures often involve forward-looking estimates, which will be difficult and administratively burdensome for many trusts to generate. In addition, concepts such as return of capital and sustaining capital expenditures do not have standardized meanings reducing the comparability of calculations.

Canadian Oil Sands, for example, undertakes capital and operating programs that are subject to uncertain approval requirements, long implementation periods, and significant cost pressures that make specific estimates in total, and by year, very difficult and subject to change. We intentionally avoid detailed guidance beyond the current year due to the uncertain nature of the business environment and the historic estimation difficulty. While we continue to provide limited guidance to investors, many issuers have stopped this practice under the Canadian and US regulations regarding secondary market liability. We therefore cannot support detailed future-oriented disclosures, such as average capital required to maintain productive capacity in the future.

Canadian Oil Sands is concerned that providing a single point estimate of DC will lead to undue reliance on an inherently imprecise number by unsophisticated investors. We agree that investors require information to make their own assessment of the stability or sustainability of future DC, but they will be better served by a narrative of expected changes and trends of key elements, rather than a specific point estimate based on significant assumptions.

If a DC calculation is to be provided, Canadian Oil Sands Trust believes it should be derived from and reconciled to the GAAP financial statements. In our opinion, this calculation would be combined with two additional disclosure requirements:

- A discussion of the reasons for the difference between DC and the actual distributions paid in the period.

- A discussion of trends or expectations that may impact future DC. Single point estimates of key elements would not be mandated, but a discussion of the key risk factors and potential impacts would be required.

We believe this historic-based approach will improve investors' understandability of DC, the reasons why management has paid distributions that differ from DC, and the factors that will influence the sustainability and stability of future DC. It will also avoid implied certainty of future DC that investors may impute into a single point, forward-based estimate.

Maintenance of Productive Capacity
Maintenance of productive capacity is a key issue in addressing stakeholder concerns regarding a trust's ability to sustain distributions in future periods. The CSA is contemplating that trusts assess their current and future capital needs in determining a DC adjustment for maintenance of productive capacity.

While Canadian Oil Sands agrees that understanding capital expenditures is fundamental to assessing cash flow maintenance and growth, we also recognize the practical limitations involved in deriving the recommended estimate. We believe these limitations will prevent trusts from complying with such a disclosure requirement. We also believe that divergent approaches to this estimate will result in information that is not comparable amongst trusts even in the same industry, and is complex and not easily understood. Investors may place undue reliance on this single point estimate.

Despite Canadian Oil Sands' long-life resource, it is debateable whether our operation can be deemed to be sustainable under the proposed productive capital DC proposals. Defining sustainability as reserves or annual productive capacity may lead to different conclusions. Even if Canadian Oil Sands could define productive capacity, classification of expenditures as maintenance or growth is subject to significant debate. While it is relatively easy to discuss these recommendations in a theoretical and conceptual framework, it is much more difficult to practically implement them and derive numbers that are accurate, relevant, and meaningful to stakeholders.

Other Adjustments
Other adjustments proposed to be incorporated in a DC calculation include non-cash items, such as asset retirement obligations and pensions. We agree that investors need to consider future cash payments for these items. However, it is difficult to derive a number that should be incorporated into a specific DC calculation. We have seen proposals ranging from deduction of the income statement expense amounts to the actual funding to an estimate of average future funding.

We support disclosure of the actual cash payments in the periods for these items combined with a discussion of trends or how these cash payments are expected to change in the near future. This approach will maintain the focus on the historical financial statements. It will also avoid the confusion caused by mixing cash and non-cash items in a calculation referred to as distributable <u>cash</u>. Some entities may not incur significant payments for these items for decades. Deduction in the DC calculation does not adequately address how the entity views these obligations in determining distributions in the current period or near future.

CONCLUSION
While this submission focuses on our key concerns with the proposed National Policy 41-201 amendments and other issues related to DC, we do agree that action is required to address stakeholders' concerns. We hope our input will help establish practical solutions.

To summarize, we support:
- Additional disclosure on the combined sources and uses of cash and avoidance of a specific DC calculation;
- If a DC calculation is required, we believe it should be based on the GAAP financial statements and provide information on DC generated in the period using actual amounts. Future oriented calculations such as maintenance of productive capacity and return on economic capital should not be included in a calculation but discussed in narrative form;

- Increased MD&A discussion of the trends or expectations of changes in the uses and sources of cash that may impact the stability or sustainability of future distributions; and
- Increased MD&A disclosure of the non-discretionary items, such as debt covenants, that may impact the ability of the trust to pay distributions.

We believe the value of disclosure changes will not arise from the derivation of a single DC estimate. The complexity and implied certainty of a specific estimate may, in fact, be the largest concern. In our view, the value is derived from a description of the key elements that influence an entity's sources and uses of cash and ultimately its distributions.

We would be pleased to discuss any of these views with the Commission staff if you believe it would assist in your understanding of the concerns raised.

Yours truly,

Canadian Oil Sands Limited,
Manager of Canadian Oil Sands Trust

Signed "Ryan M. Kubik"

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