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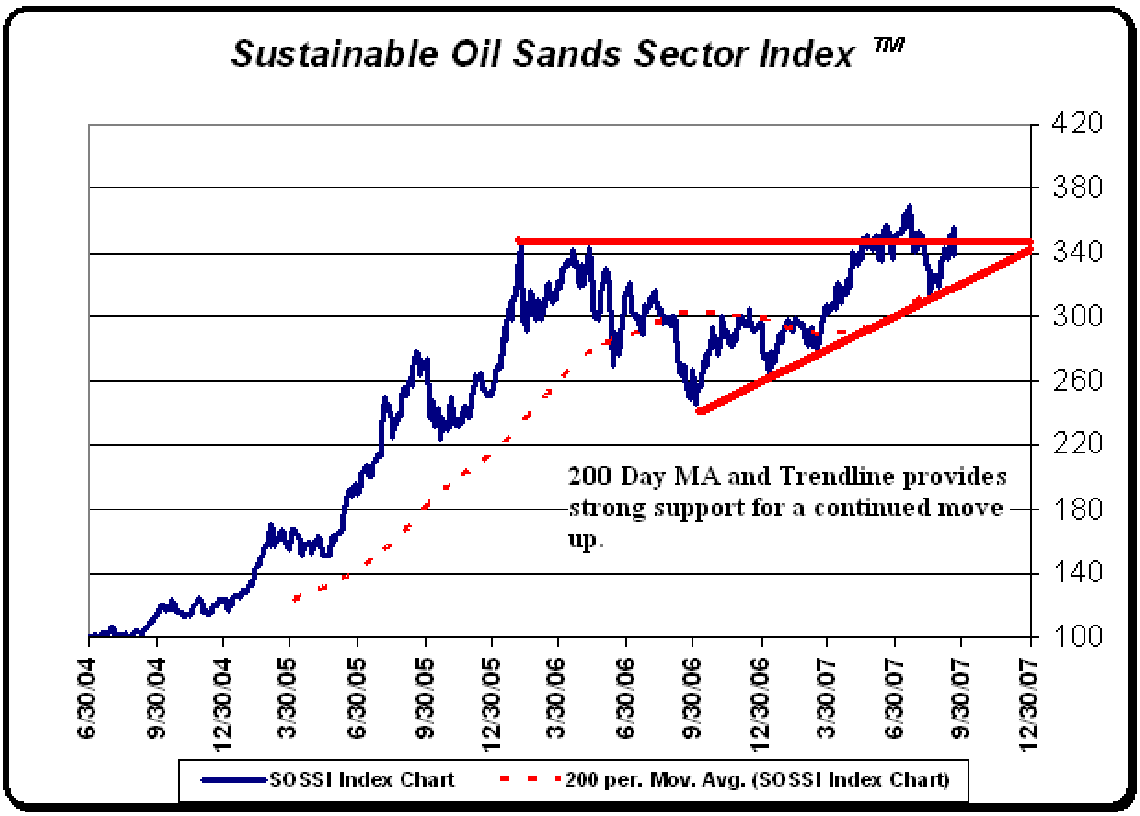
Sustainable Oil Sands Sector Index ™ (SOSSI)
Alberta Royalty Review Panel Commentary

Yesterday's publication of the report from the Alberta Royalty Review Panel resulted in one of the steepest declines in the oil sands index since it was founded. The 4.8% decline was significantly higher than the 2.7% decline in the benchmark TSX Capped Energy Index. My take is that this will be an opportunity to add to my holdings on any further pullback. The following chart of the index clearly shows that we are still in a new bull market that has been intact since the September 2006 lows. Only a drop below 320 on the index or about $21.50 on the CLO ETF on the TSX would break this bullish trend.



Before I get to my investment approach going forward I wanted to give you some of my insights on what I anticipate will occur in the energy sector near term.

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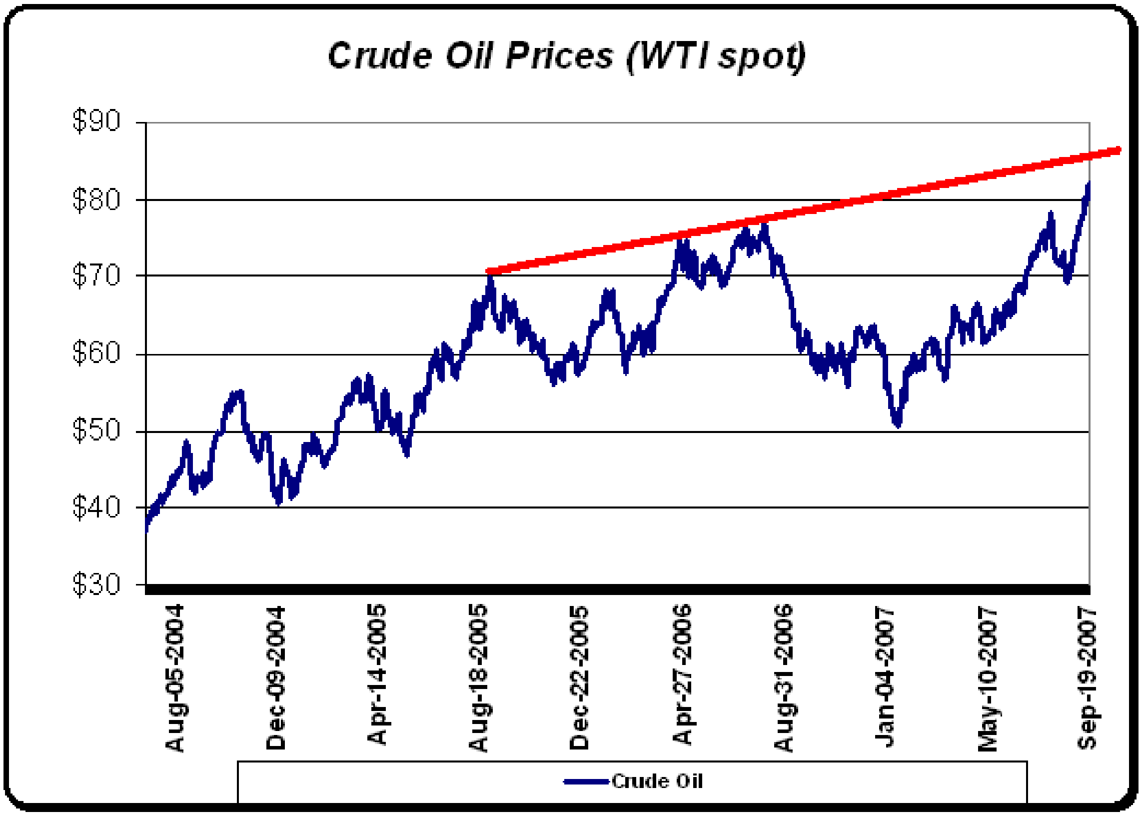
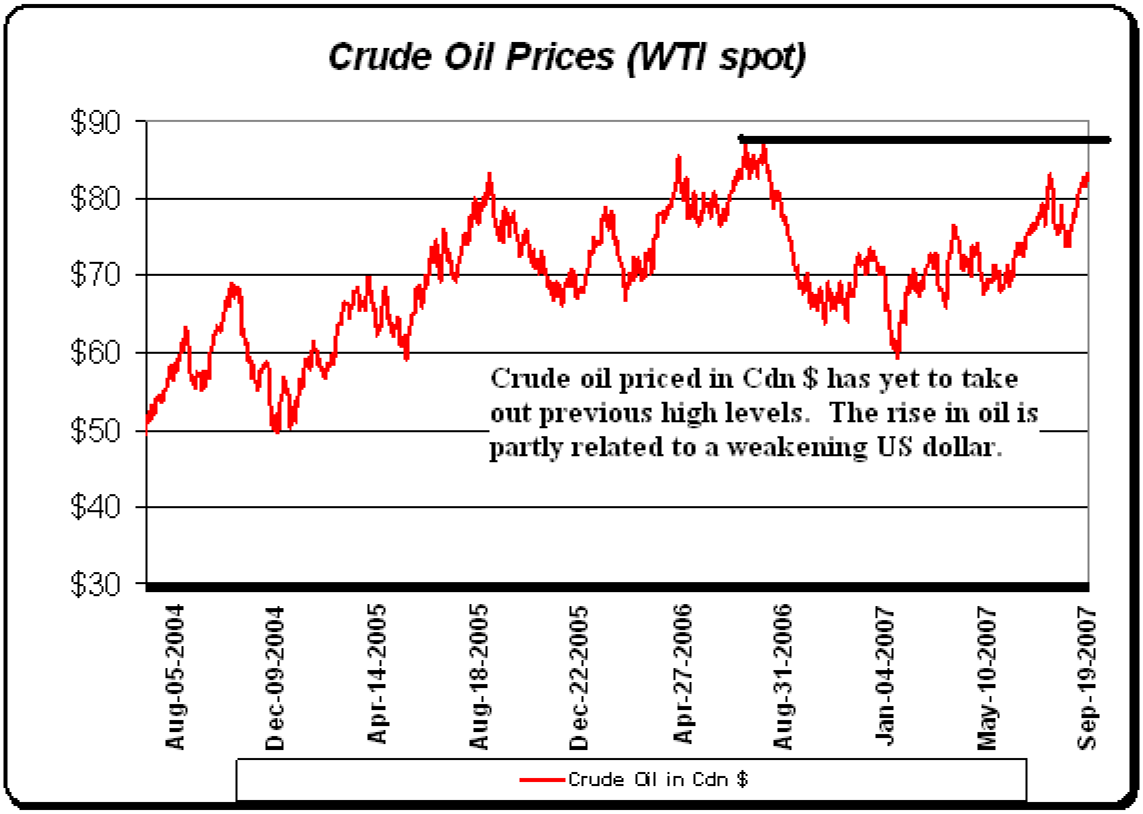
Short term Crude Oil will hit at least $84-$85 before peaking



The chart above tells me that we are close to hitting a short term high in the $84 to $85 range. This is exactly what I predicted in mid-March based on the above trend line after crude had hit bottom near $50 in January.

Crude oil demand is underestimated

Demand for crude oil is continually being adjusted upward by US government authorities and the International Energy Agency because there is little information on energy consumption outside of the industrialized OECD countries. Numerous analyst mention growth in Chinese and Indian crude oil demand but other fast growing parts of the world like the Middle East countries and Eastern Europe are also adding significantly to demand. I expect international demand to continue climbing as the rise in crude oil prices has not been as dramatic in foreign currency compared to the US dollar crude oil prices. For instance the recent $82 US price is only $83 in Canadian dollars however the all time high in Canadian dollars was on July 14, 2006 at about $87 (see chart below).



Crude oil supply will drop off suddenly and significantly very soon

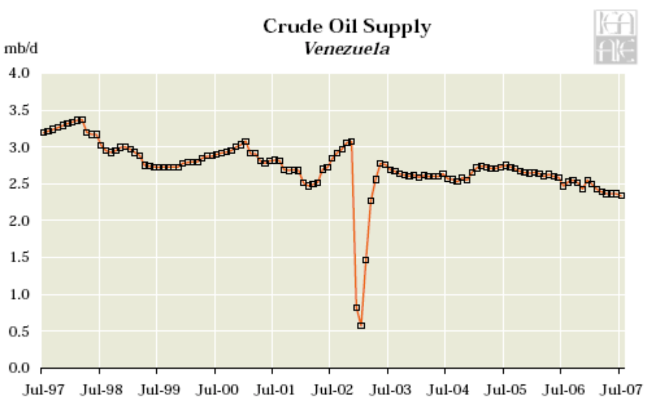
The global trend of government ownership of oil resources has resulted in a severe degree of underinvestment in energy production. The degree of underinvestment is so large that national oil companies of major producers are not able to replace production decreases from natural depletion of 5% per annum. Years of chronic neglect have accumulated and several major producers will face faster decline rates in the 10% to 20% range. Already this is occurring in Mexico's largest producing field and I suspect it will occur in Iran and Saudi Arabia very soon.

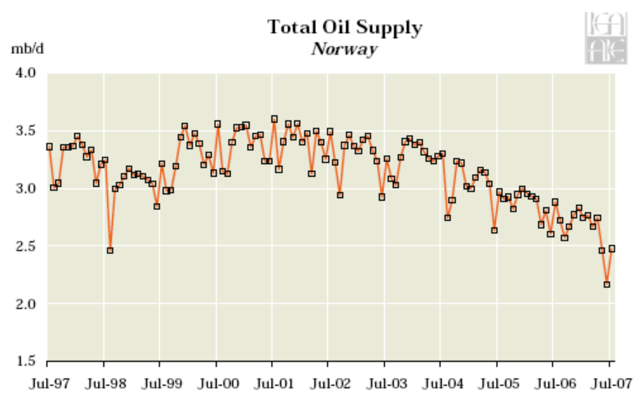
My approach to investing in the sector going forward is as follows:

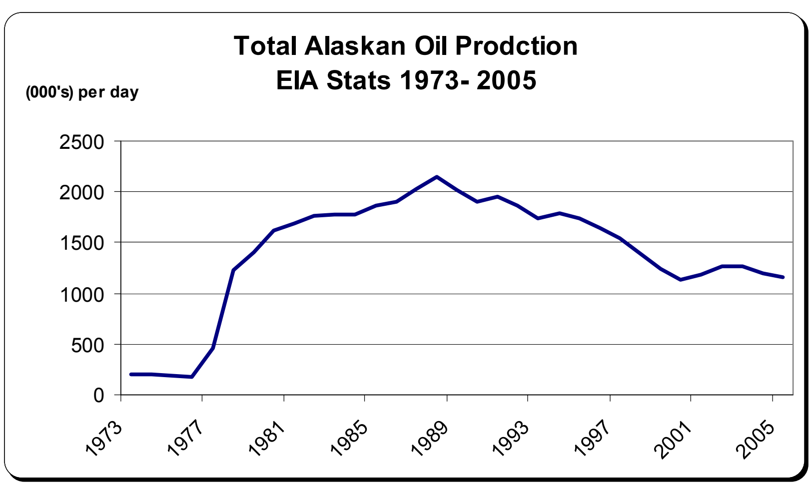
1. I believe that the sector will recover quickly from the fallout over the proposed royalty changes. I will be buying into this dip.
2. I will not be exiting long term positions with imbedded capital gains that would guarantee that I lose part of my capital to taxation. Remember this is a political report that has yet to be implement and it is still unknown if it ever will be.
3. I will focus my investing on the larger producers that are already in production, are integrated and have the ability to postpone projects that have not yet broken ground (Imperial Oil's Kearl mining project, future Syncrude expansions, etc.) I expect these companies to buy back shares aggressively and pay higher dividends if they are not burdened with having to fund these new projects.

Final thoughts

Many high profile commentators are advising investors to sell based on this report but I think that is a major mistake and is premature. The world wants more oil yet the policies of major oil producers (Canada with Alberta's oil sands and Newfoundland's offshore included) are discouraging further investment. International oil companies have been reinvesting in their own stock and/or passing on higher dividends to shareholders rather than risking investing in unfavorable regions of the world. Any major increase in the oil sands royalty regime, in my humble opinion, will and should result in an industry wide boycott of further investment in the sector. The history of the oil production around the world strongly indicates that higher regulatory and tax burdens inevitably results in lower production in the future. It is interesting to note that the Alberta Royalty Review Panel noted that several regions had significantly higher share of oil revenue. In particular they mentioned Norway (76%), Venezuela (72%) and Alaska (66%) as justification that current 47% in Alberta is too low and that the proposed 60% rate would still be competitive. Below is the long term production chart of those regions which clearly supports my view that the higher rates will at least slow production growth in the future. In the end the tax will result in less investment, less production and of course less tax revenue for the Alberta government. I don't think any Albertan wants that.







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On a final note, there is a clear bias in the report to encourage high value upgrading inside the province which will benefit several new merchant facilities that are being planned for the Edmonton area. Integrated projects would pay only 45% rate compared to 60%+ for companies who pipe bitumen to US refineries. This will hurt recently announced deals such as Western Oil Sands/Marathon and Encana/ConocoPhillips which would use spare capacity in the US to upgrade Canada's oil sands in a low cost and effective manner. I see this as having three major consequences;

1. Inflation and growth in Alberta will accelerate with having to build new facilities
2. Cost will spiral out of control and hurt the economics of the projects
3. More local upgrading will dramatically increase pollution and greenhouse gases

I urge investors and energy company executives to fight these measures at all costs and ensure that government interference not be allowed to override sound business investment decisions.

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