

LEITH WHEELER INVESTMENT OUTLOOK



First Quarter 2008

Our New Year's Resolution – Keep an Eye on Natural Gas Prices

While some investors are looking for cheap condos in Miami or buying Google stock at US\$700 a share, Leith Wheeler is keeping a close eye on natural gas prices. And why might that be? With crude oil at US\$100 a barrel, we think natural gas prices are too low.

Oil prices have moved from US\$18 per barrel in 2002 to US\$100 per barrel today, which represents a 455% increase in five years. However, not all energy companies have fared as well. Natural gas prices failed to follow oil prices higher in 2007 and stocks with exposure to natural gas declined.

US\$100 oil and US\$7.50 natural gas – it doesn't add up!

Natural gas prices are influenced by world oil prices as they are substitutes for one another in certain applications. Fuel-switching takes place at power generation and industrial facilities that can use either hydrocarbon as a fuel source. This tends to increase the demand for gas when oil prices are high and decrease the demand for gas when gas prices are high.

Over the last fifteen years, the historical relationship between the price of oil and the price of natural gas has averaged eight to one on a price-ratio basis. On an energy-equivalency basis, the ratio is six to one. That is, six mcf (thousand cubic feet) of gas has approximately the same energy content as one barrel of oil. Gas tends to sell at a slight discount to oil over the long term, likely because it costs more per unit of energy to ship to the end consumer than oil.

Based on US\$100 oil and US\$7.50 natural gas, the ratio is currently at 13 to 1. If gas prices were to move more in line with the long-term average of eight to one and oil remained near US\$100, gas prices would be near US\$12 per mcf. Increasing demand for gas and lower demand for oil should push natural gas prices higher and oil prices lower. We believe natural gas prices are simply too low.

The future looks brighter for natural gas

Global natural gas **demand** is expected to grow at more than double the rate of oil demand over the next twenty years. Demand is driven by a myriad of factors such as weather, price, efficiency, and the availability of substitutes. Efficiency and environmental benefits should make natural gas the fuel of choice. The biggest importers of natural gas are Asia, North America, and Europe. It is estimated that North America will have to, at a minimum, triple its level of imports of natural gas over the next decade due to lower levels of domestic production and increasing demand for power generation.

North American **supply** growth is driven by a number of factors, such as the availability of the resource, producer cash flows, transportation, the marginal cost of supply and imports. Canada is the third largest producer of natural gas in the world and the number one supplier of natural gas to the United States (Canada exports more than half of its daily production to the U.S.). Unfortunately for the U.S., Canadian exports of natural gas are declining because of rising demand in the Alberta oil sands and flat production in Canada. The Alberta oil sands are large net buyers of natural gas for use in the bitumen extraction process.

The U.S. is the largest consumer of natural gas in the world. They will need to increase domestic production and/or non-North American imports to satisfy their appetite for natural gas. North American gas producers have spent more money and drilled more wells over the past decade than ever before. However, they are finding fewer and less productive pools of gas for each well drilled.

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According to research by Sanford C. Bernstein, reserves per well drilled have declined by eight to ten percent per annum while the number of wells drilled has increased by fifteen percent per annum over the last ten years.

The North American basin is a mature basin. That means production has been on stream for many years and the typical gas well is producing less gas each year as the field pressure declines. Offsetting normal field declines is very capital intensive in a mature basin. It requires on-going investment into exploration and development. From our perspective, this bodes very well for the energy service companies as it requires significantly more services per each unit of output. Producers are spending an increasing amount of capital on seismic, drilling, fracturing and compression services in order to produce their wells at the fastest rate possible without damaging the reservoir.

We believe the cost of finding, developing, and producing a natural gas field to be at least US\$8 per mcf in North America. With the price of natural gas trading at US\$7.50 per mcf, natural gas prices are too low to encourage enough investment in exploration and development. Therefore, prices must rise to stimulate investment in the basin.

Without domestic supply growth, the U.S. needs Liquefied Natural Gas!

If domestic supply isn't growing, the U.S. will need another major source of incremental supply. This source of supply is expected to be liquefied natural gas (LNG). LNG is gas that at one point was "stranded", meaning it had no indigenous market, but through advances in technology and rising global demand, it is now feasible to transport it globally on specialized vessels. The single most important implication of the global energy market turning to LNG is the creation of a global market for natural gas. In the past, prices in any region were the result of local supply and demand factors. Now, with a growing LNG capability there will be a "world clearing price" for gas. Supply will go to the highest bidder.

Our research indicates that the selling price of LNG in India, Japan and Korea is 50 to 80 percent higher than the current U.S. natural gas price. If customers in India, Japan or Korea are willing to pay US\$12 to US\$16 per mcf, will the U.S. be able to attract this essential source of supply at US\$8 per mcf? Probably not! Natural gas prices will have to move higher in North America to attract LNG.

Why are natural gas prices so low right now?

Weather is a big driver of natural gas demand and over the past two years North America and Europe have experienced warmer than normal winters. This has led to a larger than expected build in natural gas inventories and lower natural gas prices. Another factor keeping natural gas prices too low, but could be a catalyst for a move higher, is the role speculators are playing in the market. Based on our research, speculators have taken the most bearish position on record against an increase in natural gas prices. The last time such an extreme bet was taken it had dire consequences for the trader and the firm. It was the fall of 2006 and an energy trader at a large hedge fund bet big on a winter rally in natural gas prices. It failed to materialize! We are wary of such an extreme view, especially in light of the fundamentals we discussed earlier.

What does this mean for your energy investments?

Our view is different from most and so too is our investment stance. We believe natural gas levered businesses, whether they are natural gas producers or natural gas service companies, have a strong future. We expect companies such as Trican Well Service, Enerflex Systems and Savanna Energy Services to see a rebound in their share prices in 2008. Enerflex and Savanna are trading near the replacement value of their equipment and Trican is one of the best run energy service companies in Canada. Finally, we believe EnCana has a bright future. EnCana has the largest and lowest cost inventory of natural gas opportunities in North America. They are also the largest natural gas producer in North America. Rising natural gas prices should be the catalyst for these stocks to produce excellent returns.

Overall, our Canadian portfolios are still light on oil stocks, but we are finding more value in natural gas levered businesses given our bullish view on natural gas prices. Keep an eye on natural gas prices in 2008, we sure will.

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