LEITH WHEELER INVESTMENT OUTLOOK

Leith Wheeler
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Expensive Words

What are the most expensive words in investing? "It's Different This Time".

Those words cost investors dearly because they attempt to justify unusual valuations and rationalize why the laws of supply and demand should be suspended. These words were applied to the "idea" stocks of the tech boom. Now, it's oil and oil stocks.

Investors need several conditions to be met to believe "It's Different This Time". The first is that enough time must have passed since the "last time" so that it is either forgotten or was not experienced by the current crop of investors. The high tech valuation bubble that peaked in 2000 was not the first time high tech stocks soared and crashed. In the mid 1960's the market went silly over the then darlings of high tech. By the late 1990's, the market did not remember and could not see the parallels between the Fairchilds and Polaroids of the1960's and the Nortels of the 1990's. Now, enough years have passed since the early 1980's, the last time the market believed in $100 oil, for the market to have forgotten how supply and demand ultimately met at a much lower price. The result was an energy market train wreck with a leading company of the day, Dome Petroleum, and many smaller oil companies, going bankrupt.

The other prerequisites to believe "It's Different This Time" are plausible reasons why it could be different this time. In the case of high tech, the last peak was supported by the widely accepted idea that the internet would change the way business is done and how people communicate. There was a good deal of truth to this idea; however, extreme share valuation concerns were brushed aside. So too was the notion that abundant and low cost capital for high tech businesses would result in oversupply.

Today it is about oil. The drumbeaters say "It's Different This Time" because of two new factors: the demand from China and the lack of new supply. While these are plausible arguments, we don't believe the laws of supply and demand have been suspended and therefore we don't believe in the sustainability of today's oil price, much less the sustainability of the $100 per barrel and the higher numbers now being advanced by bank economists and other "experts".

Oil prices are difficult to forecast. Our experience is that most oil price forecasters get it wrong. Even the futures market is a poor predictor. During the run up in oil prices over the last four years, the price for oil delivered twelve months in the future has been lower than the price for immediate delivery. The futures market was predicting a drop in the price of oil. Just the opposite proved to be true. One group of forecasters with a worse record at predicting the oil market than the futures market, and bank economists, are the oil companies themselves. Most Canadian oil producers have been heavy sellers of oil and gas futures contracts over the past several years. If they had the presence of mind to believe in higher energy prices three or four years ago, they would not have locked themselves into forward contracts at low prices. These contracts cost the companies hundreds of millions of dollars. Today, most oil companies believe that higher prices are here to stay and, expecting oil to go even higher, they are no longer locking in the price of their future oil production even though the price for oil delivered in the future is much higher now. Our caution is to take advice from oil price "experts" with a large measure of salt.

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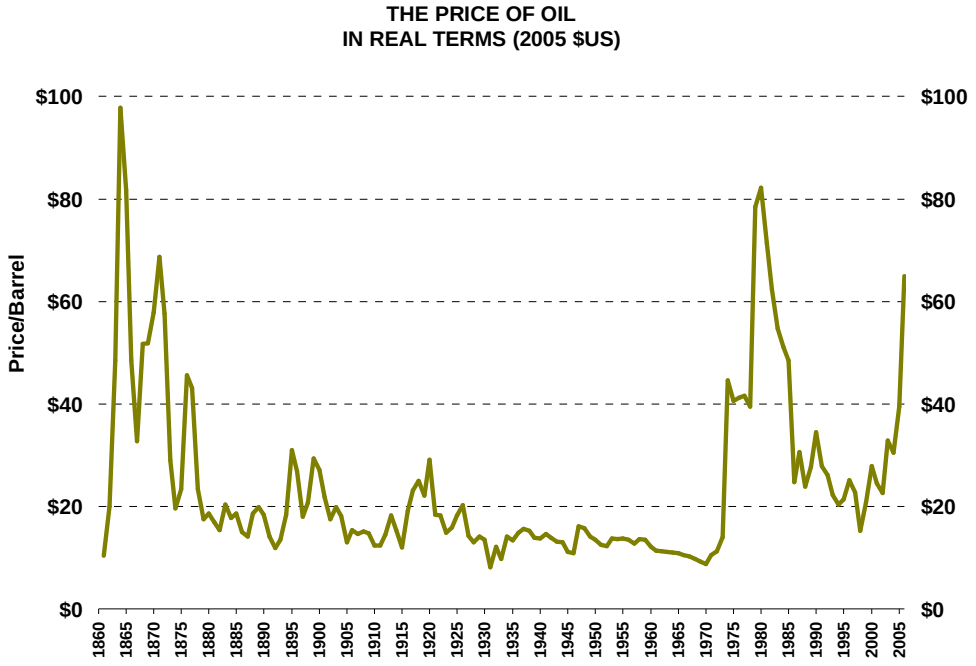
It appears that the market consensus is that the current price, or prices above $50 per barrel, are sustainable with a good chance that prices could move to and stay well above $100 per barrel. Feeding this market view is a recent book by Matt Simmons called *Twilight in the Desert*. Simmons, an investment banker and consultant, estimates that the world's largest oil producer, Saudi Arabia, produces 90% of its oil from just six fields. Simmons claims one field, Ghawar, accounts for between 6% and 8% of world production. Simmons maintains that not much is known about these fields because the Saudis don't allow independent reserve audits. The Saudis have countered that they have not been invited to count the gold bars in Fort Knox. Simmons argues that these are aging fields, which have been produced too hard, and that rising water production indicates oil production declines, not increases, lie ahead. For those of us without reservoir engineering backgrounds these conclusions sound both plausible and scary. However, we have reviewed Simmons' thesis with experienced reservoir engineers who strongly disagree with his interpretation and conclusions.

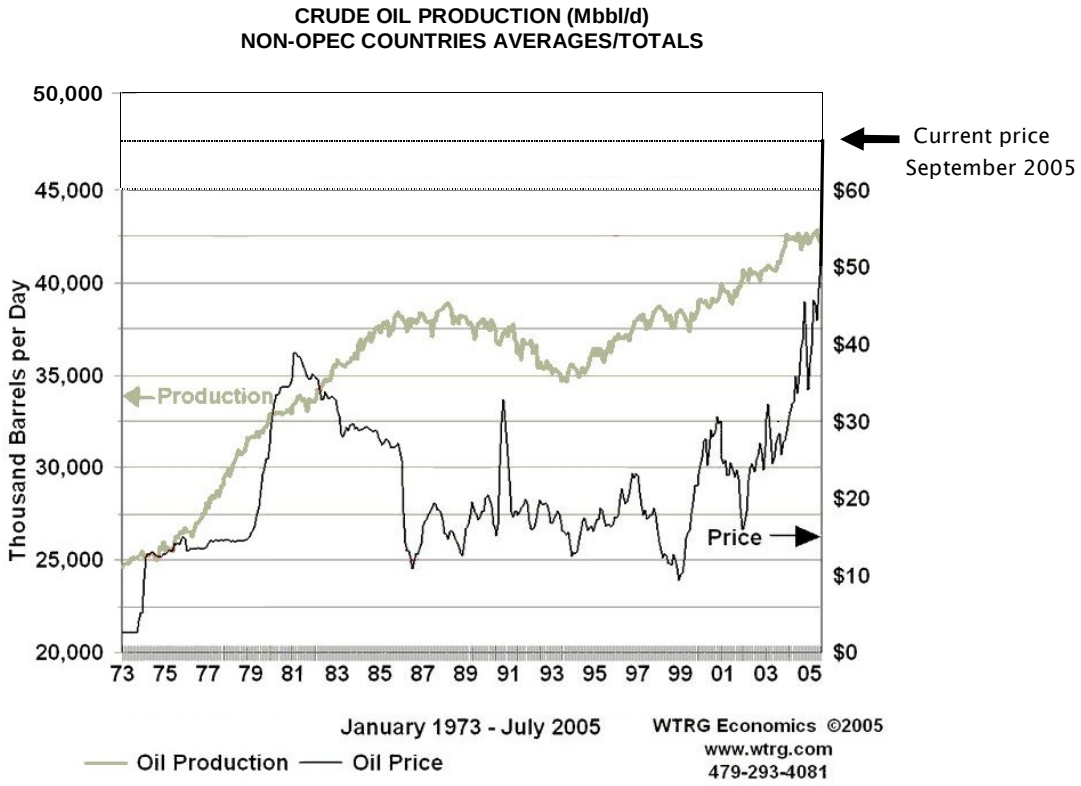
Daniel Yergin, Chairman of Cambridge Energy Research Associates (CERA) and author of the book *The Prize*, has a different view than Simmons. Yergin says CERA has looked at oil production around the world on a field-by-field basis. They see the potential for "an unprecedented build up of oil supply" which would outstrip the likely increase in demand. Their analysis shows that oil productive capacity could increase from the current level of 85 million barrels per day to 101 million barrels by 2010. Interestingly, CERA's forecasts were based on oil prices in the range of $25 to $30 per barrel. With higher prices, the supply response would be even greater. Yergin points out that the oil business has a history of shortages and high prices followed by surpluses and lower prices. At each time of shortage there has been gnashing of teeth and predictions that the world was out of oil.

Oil production has a long lead-time. Low oil prices from the mid 1990's to 2000 resulted in lower exploration spending and reduced the incentive to build the pipelines and facilities needed to bring on the more remote fields. Projects that would never have made it to the boardroom a few years ago are now being advanced because of the rise in the price of oil. With the industry booming, people and equipment are the raw materials in short supply. Given some time, increased production should follow.

We often hear that "the price of oil is lower today in real terms than it was in the early 1980's" as justification for why today's oil price is sustainable. The chart below shows a real oil price that covers the entire "age of oil". Half that time, oil prices were below $18.17 in today's dollars. While demand has grown, technological advances and the supply of low cost Arabian oil have worked to keep real prices relatively flat. The chart shows that while oil was expensive in the early 1980's, this peak was short lived. Within five years of the 1980 peak, oil was selling for about 1/3 of its peak level.



The chart below shows non-OPEC oil production and the price of oil. The green line shows production while the black line shows price. Look at the jump in non-OPEC production in the 1980's in response to the price increase. With this jump in competing production, OPEC had to slash production from over 30 million barrels a day to about 15 million. Eventually OPEC, and especially Saudi Arabia, decided they had lost enough market share and that they needed to shake out the competition. So the Saudis increased production and drove down the price of oil. With a lower price, industry shelved marginal projects and non-OPEC production dropped. Today OPEC production has finally returned to the levels reached in the early 1980s. No wonder that OPEC doesn't have a lot of spare capacity. They have been sitting on spare capacity for over 20 years and did not have the need to expand.



The lesson from the 1980's cycle, and for that matter, the many supply squeezes and busts that characterize the history of oil, is that oil is a commodity, and commodities respond to price.

How will today's price affect oil supply and demand? What about China? Let's put China in perspective, of the 85 million barrels of oil consumed daily, China accounts for less than 7 million barrels. If China continues to grow apace, it will eventually push the long-term price of energy up. In the near term, new supply, substitution and conservation will meet China's needs.

On the supply side, there is CERA's field-by-field work that indicates growing supply from known discoveries. Oil companies are also increasing exploration spending because, at these prices, just about any exploration program makes sense. This spending will result in higher production. High prices also extend the economic life of an oil well. This is as good as finding new reserves. Typically, any oil well will experience a decline in production as it ages. When the fixed costs of operating the well exceed revenues, it is shut in. With higher prices, that well remains economic for a longer period and continues to produce. In this way, high prices "create" new reserves in known oil pools.

High oil prices also bring on remote reserves. We see this in Central Asia where new oil pipelines are bringing out once stranded oil. More pipelines mean lower costs. Lower costs and higher prices mean more capital is going to look for new oil and develop known oil in these remote areas. Closer to home, the tar sands are a striking example of how higher prices induce more production. Only a few years ago oil companies pleaded that the high investment and high operating costs of tar sands projects required a lower government royalty if there were to be any new plants. Now with higher prices, the plans for tar sands production may exceed the labour available to build them. The prices paid at auction for oil sands leases has skyrocketed and

companies like Teck Cominco have paid huge premiums to get into leases that were available at a fraction of the current price only a year ago. New technologies, such as Nexen's Opti project are also being applied to the tar sands. This technology eliminates the purchase of natural gas to produce and upgrade the heavy oil. As the price of natural gas rises with oil, the value of this technology increases and its application will expand.

In addition to an oil supply response, we can expect a substitution response. Natural gas will be substituted for oil where it is economic. Petro Canada is working on a project to bring Russian gas to Canada in Liquified Natural Gas (LNG) form. They claim this project makes sense at a gas price of US $4 or greater. With natural gas at over US $10/mcf today, we can expect large international gas deposits, which are currently without markets, to be developed and delivered in liquid form. In addition to natural gas, other forms of energy will emerge. We will see new projects for solar, wind, geothermal and tidal power emerge. Ethanol and organic fuels will be mixed into gasoline and diesel. All these sources will reduce the amount of oil required for a given level of GDP.

Finally, there will be a demand response. Consumers now believe that high prices are here to stay. They will respond. Out with the SUV, in with the Prius. There will be a refocus on energy efficiency not just by consumers but also by manufacturers and distributors. High energy prices mean higher production costs for virtually every industry. Changes that reduce the use of hydrocarbons will be a competitive advantage.

So what oil prices do we look for? We would not be surprised if the recent highs for oil are the highs for this cycle. Over the next couple of years the price of oil is more likely to work its way lower than it is to move up. A sustainable oil price in a range of low to high $30/barrel zone is our best guess. This price would produce excellent returns for high cost projects like the tar sands, would be sufficient to maintain high levels of exploration and would bring on new reserves. It would not be so high as to kill demand and would reduce the rate of substitution. Our view is that the cycle low price for oil is likely to be substantially higher than the mid teens of the last cycle because OPEC is not trying to re-establish market share and because the decline in the US dollar requires a higher price for foreign producers.

This view is contrary to the consensus and our investment stance is therefore also contrary. Today we have a very small holding in oil stocks. This hasn't always been the case. We were more heavily weighted when oil prices were lower and oil stocks were being ignored. But, oil is a commodity and, just like other commodities, oil responds to price.

It's Not Different This Time.

Newsworthy

We have recently created a subsidiary, Leith Wheeler Investment Funds, to provide individuals with access to our services in the provinces of British Columbia, Alberta, Saskatchewan, Manitoba and Ontario. Our Investment Funds offer a strong ten year performance record, along with fees that are far below the industry averages. We invite your family or friends to call us at 1-888-292-1122 or visit www.leithwheeler.com

Leith Wheeler is proud to once again be a corporate partner with the Playhouse Theatre Company. Our sponsorship of the production of *The Syringa Tree* kicks off the 05/06 season on October 8th. www.vancouverplayhouse.com

Leith Wheeler is also proud to be an event sponsor with Music in the Morning, and the upcoming concert series featuring Beverly Johnston and Lorna McGhee begins October 18th. www.musicinthemorning.org

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