



HORNSBY & COMPANY, INC.

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Energy Risk
Management Services

U.S. Natural Gas Perspectives Monthly Review and Outlook

Summary

Since our last monthly report the prompt NYMEX natural gas contract has risen about \$.75 per mmBtu. Aiding the modest recovery have been periodic cold spells in combination with weekly working storage draws in excess of consensus expectations. The most important factor, however, has likely been relatively strong crude oil prices as we begin 2008 as anticipated, reflecting early-year allocation to passive length by pension funds and other investors in response to the positive index returns generated in 2007. In performing a post mortem on our gas price forecasting of last year, our forecast 2007 average expected in each of our monthly reports from December 2006 through November 2007 yielded an average value of about \$7.22 per mmBtu, compared to the actual average for calendar 2007 of \$7.12 per mmBtu. Although we made periodic modest adjustments as the year proceeded, helping our effort was our conviction that the winter curve, steep in contango under the expectation of tight winter gas supplies, would flatten as we proceeded through fall and early winter.

As we provide our first outlook for 2008 in the New Year, we have made modest revisions to our forecast natural gas balances. A reduction in forecast industrial sector demand has been more than offset by other revisions, leading to a somewhat larger net draw in working storage for 2008 than previously anticipated. As you are aware, since late December we have been discussing the possibility of revising up our forecast WTI average for this year to a value which would come in above current consensus expectations and we hope, after observing price behavior in January, to finalize our outlook one way or another over the next three weeks. Since last July our forecast prompt NYMEX/Henry Hub average for this year has been \$7.50 per mmBtu, and in this report we have not revised this outlook. However, if we end up boosting our WTI outlook we would also revise up our natural gas price forecast to retain internal consistency, particularly since our improving natural gas balances imply the likelihood of substantial active fund short covering. Although our research has suggested that due to a smaller percentage of open interest such active funds do not necessarily move price at the margin to the extent they do in the crude oil pit, given the extraordinarily high net short positions in natural still retained at the present time there should be a positive impact given any major reduction of net short positions.

+ U.S. natural gas consumption is forecast to rise by 1.8%, or some 400 bcf this year.

+ U.S. dry gas production is expected to gain by 0.4%, or about 75 bcf in 2008.

+ Our balances imply a net draw in working storage this year of around 320 bcf.

Viewpoint

Since our last monthly report the prompt NYMEX natural gas contract has risen about \$.75 per mmBtu. As we issue this report the prompt contract is trading around \$8.25 per mmBtu on the back of constructive weekly storage data.

Aiding the modest recovery have been intermittent cold spells in combination with weekly working storage draws that periodically have come in larger than consensus expectations.

Within this context, CFTC-reporting managed commodity funds have been doing their best to hold natural gas prices down by building up net short positions. On December 24 when the prompt NYMEX natural contract settled at \$7.120 per mmBtu, such funds held futures-only net short positions totaling an all-time record of 112,546 contracts.

Since that point in time we believe the recovery in natural gas prices has reflected some close out of net short positions as we move into winter.

The most important factor, however, has likely been relatively strong crude oil prices as we begin 2008 as we had anticipated, reflecting early-year capital allocation to passive length by pension funds and other investors in response to the positive index returns generated in 2007 that came about through a substantial year-end-to-year- end gain in crude oil prices, aided by the market move into backwardation in the second half of 2007 leading to a positive “roll”.

In performing our customary post mortem on our gas price forecasting effort for last year, our forecast 2007 average expected in each of our monthly reports from December 2006 through November 2007 yielded an average value of about \$7.22 per mmBtu, compared to the actual average for calendar 2007 of \$7.12 per mmBtu.

Although we made periodic modest adjustments as the year proceeded, helping our effort was our conviction that the winter curve, remaining steep in contango for much of last year under the expectation of tight winter gas supplies, would both “flatten” and weaken as we proceeded through fall and early winter.

As we provide our first outlook for 2008 in the New Year, we have made some modest revisions to our forecast natural gas balances. We have trimmed our expectations for industrial natural gas demand, becoming more conservative

on the expected gain in manufacturing output for this year, but we still do not anticipate an official recession.

This adjustment has been more than offset, however, by upward revisions to residential sector demand as well as adjustments to the customary “balancing item” and other line items given where storage ended in 2007. The net result is a somewhat greater forecast net draw in working storage for 2008 than previously anticipated.

With regard to price, as you are aware since late December we have been discussing the possibility of revising up our forecast WTI average for this year to a value which would come in above current consensus expectations and hope, based on price behavior in January, to finalize our outlook one way or another over the next three weeks.

Since last July our forecast prompt NYMEX/Henry Hub average for this year has been \$7.50 per mmBtu, and in this report we have only revised up this expectation by \$.05 per mmBtu to \$7.55 per mmBtu to reflect our larger storage draw.

However, if we end up boosting our WTI outlook we would also revise up our natural gas price forecast to retain internal consistency, particularly since our improving natural gas balances imply the likelihood of substantial active fund short covering. In the price section of this report we consider such a sensitivity analysis.

Although our research has suggested that due to a smaller percentage of open interest such active funds do not necessarily move price at the margin to the extent they do in the crude oil pit, given the extraordinarily high net short positions in natural still retained at the present time there should be a positive price impact given any material reduction of net short positions.

Demand: Review and Outlook

As we issue this report the market is increasing its odds of a U.S. recession this year given a weak retail environment and other evidence, not to mention the impact of substantially higher refined product prices. In an effort to soothe traders and investors, however, Fed Chairman Bernanke indicated that the U.S.

outlook had worsened and that the Fed stood ready to act aggressively if needed to support economic growth.

Whether the implied 50 basis point rate cut at the end of January will be sufficient or not remains to be seen. There is no guarantee that whatever the Fed does will prevent what many economists now feel is the inevitable.

In terms of the recent picture, our customary table below reveals the November performance versus the prior year of the eight largest industrial consumers of natural gas. Compared to their October performance versus October of 2006 the industries turned in somewhat of a mixed bag, but the three largest consumers accelerated their output gains over last year.

**Eight Largest Industrial Consumers
of Natural Gas
November Manufacturing Output**

Industry	YOY %Chg. Output
Chemicals	+2.3
Petroleum and Coal	+1.8
Primary Metals	+6.9
Paper	-3.7
Food	+1.5
Non-Metallic Mineral	+1.5
Fabricated Metal	+2.9
Transportation Equip.	+2.1

Right or wrong, we have not assumed an official recession for 2008 as technically defined, nor do we now despite the uncertainty. Having said this, however, based on recent data and trends we have trimmed our expectations for manufacturing growth for this year.

Our long-standing Base Case had assumed an average rate of growth in manufacturing of 2.5% in 2008. Our current balances now assume growth of 2.0%. This implies that industrial natural gas demand will gain by 0.4%, or some 25-30 bcf this year, a downward revision from last month's report by about 60 bcf.

Under our customary assumption of normal weather, however, the residential and

commercial sectors will witness significantly higher growth, aided by our upward adjustment to reflect our estimated new hookup impact at the expense of heating oil. Electric utility demand should rise more closely in line with expected gains in manufacturing activity.

Overall, we are now looking for total U.S. natural gas consumption to increase by 1.8%, or around 400 bcf this year, a net upward revision from last month by 40 bcf.

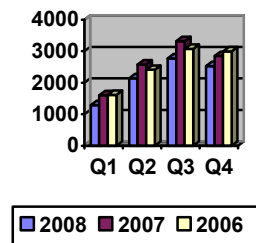
**Supply:
Review and Outlook**

As we moved into the fourth quarter it appears that the U.S. gas market was not sufficiently robust to attract incremental LNG cargoes, and as a result imports came in somewhat below original expectations, partially offset by stronger pipeline volumes from Canada.

For 2008 we have made some adjustments to our expectations from both sources, with the net result a modest downward revision in forecast total gross imports.

With domestic dry gas production expected to rise by the same percentage as previous reports, the lower total supply combined with modestly higher demand leads to a larger forecast net working storage draw for 2008 than we had previously anticipated, supporting even more our case for firming natural gas prices relative to oil.

**End-Quarter
Working Gas Storage Levels
(BCF)**



Under our current Base Case, end first quarter working storage is expected to stand at a bit under 1.3 tcf, implying a 315 bcf deficit to end-March 2007. This compares to the current

storage “underage” of 282 bcf. For 2008 as a whole, our balances imply a net storage draw totaling about 320 bcf, larger than forecast last month by some 165 bcf.

Implications for Price

The net impact of our revised path in working storage for this year is a modest fine tuning of our expected prompt NYMEX/Henry Hub average for this year by \$.05 per mmBtu from \$7.50 per mmBtu to \$7.55 per mmBtu, with the adjustments coming in the first and fourth quarters.

Henry Hub Price Outlook Average for Month of March 2008 (\$/mmBtu)

1990-2007 Relationships **\$3.00(E)**
1990-1999 Relationships **\$1.65(E)**
2000-2007 Relationships **\$4.50(E)**

2000-2007 Relationships
Plus Oil Premium **\$7.55(E)(a)**

a) @ 205 cents per gallon distillate and \$75.00 per barrel WTI.

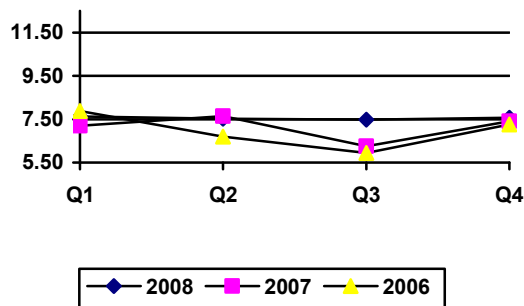
However, as our customary table suggests above, we have not yet revised our March (basis April NYMEX) target of \$7.55 per mmBtu. As we issue this report the April NYMEX contract is trading some \$.60 per mmBtu above our target even as crude oil weakens, reflecting in part the impact of traders and funds unwinding short natural positions that were hedges against their crude oil longs.

Although in this report we have retained our Base Case outlook for WTI, as we have discussed in previous reports we wish to finalize our Base Case for 2008 once and for all, right or wrong, by the end of January. As we have suggested, any revisions to our average would be up and not down.

We have contemplated an alternative case which embraces an even greater influx of passive length into oil than we had anticipated, as well as a more robust demand environment, e.g. that U.S. gasoline demand begins to recover this year and

not decline. This scenario suggests a 2008 WTI average of \$97.50 per barrel, well above current consensus expectations.

**Henry Hub Prices
2006-2008
(Dollars per MCF)**



Under this Base Case annual average and assuming a normal seasonal pattern which suggests a trough in the first quarter, it would imply April NYMEX WTI averaging about \$88.00 per barrel.

Plugging this crude oil price and the implied distillate value into our March pricing model and leaving the gas balances unchanged, the April NYMEX natural target would jump to \$9.45 per mmBtu from our current \$7.55 per mmBtu.

As we indicated we are reserving final judgment until we observe January WTI behavior in the context of an expected recovery in U.S. crude oil stocks, any Fed moves, the dollar, and other factors both fundamental and financial in nature. By the time we issue our next monthly natural gas report, however, we expect to incorporate our revisions, if any, at that time.

January 10, 2008

U.S. Natural Gas Supply and Demand Balances
2007-2008
(Billion Cubic Feet)

	Q1	Q2	Q3(E)	Q4(E)	2007(E)	%Chg 07-06	Q1(E)	Q2(E)	Q3(E)	Q4(E)	2008(E)	%Chg 08-07
Supply												
Total Dry Gas Production	4,591	4,694	4,783	4,766	18,834	1.6	4,609	4,713	4,802	4,785	18,910	0.4
Withdrawals From Storage	1,791	241	382	648	3,063	22.9	1,986	395	306	525	3,212	4.9
Supplemental Gaseous Fuels	18	12	15	16	62	-0.3	19	12	15	16	63	1.5
Imports	1,153	1,133	1,167	1,147	4,599	10.4	1,152	1,144	1,176	1,154	4,625	0.6
Canada	968	853	898	897	3,616	1.3	949	836	880	879	3,544	-2.0
LNG	184	280	269	250	983		203	308	296	275	1,081	
Other	0	0	0	0	0		0	0	0	0	0	
Balancing Item	82	190	(138)	(175)	(41)		0	0	0	0	0	
Total Supply	7,635	6,270	6,210	6,402	26,517	4.5	7,766	6,264	6,299	6,480	26,809	1.1
Disposition												
Additions To Storage	327	1,209	1,089	510	3,135	7.2	330	1,221	1,100	515	3,166	1.0
Exports	203	178	187	205	772	6.7	180	185	185	205	755	-2.2
Consumption	7,105	4,883	4,934	5,687	22,609	4.1	7,256	4,858	5,014	5,760	22,888	1.2
Lease And Plant Fuel	281	288	292	286	1,147	1.0	277	283	288	287	1,135	-1.1
Pipeline and Distribution Use	186	129	137	145	597	4.8	152	151	154	158	614	2.9
Residential	2,316	762	351	1,361	4,790	9.9	2,436	714	354	1,375	4,879	1.9
Commercial(a)	1,260	562	386	829	3,037	6.1	1,324	525	387	825	3,060	0.8
Industrial	1,755	1,534	1,551	1,688	6,528	-0.3	1,735	1,549	1,573	1,712	6,569	0.6
Electric Power	1,307	1,608	2,218	1,378	6,511	4.2	1,332	1,637	2,259	1,403	6,631	1.8
Total Disposition	7,635	6,270	6,210	6,402	26,517	4.5	7,766	6,264	6,299	6,480	26,809	1.1
Addendum:												
Net Storage Injections	(1,464)	968	706	(138)	72		(1,656)	826	794	(10)	(46)	
End Period Working Gas In Storage	1,603	2,580	3,284	3,146	3,146		1,490	2,316	3,110	3,101	3,101	
Henry Hub Price (Dollars Per mmBtu)	7.20	7.64	6.25	7.57	7.16	3.2	7.42	7.50	7.48	7.58	7.50	4.6
Gas Wells Drilled					34,746	10.0					38,220	10.0
Total Discoveries(Bcf)					15,636	-1.0					15,288	-2.2
Discoveries Per Well(Bcf)					0.45	-10.0					0.40	-11.1
Total Revisions and Adjustments(Bcf)					4,000	0.0					4,000	0.0
Total Reserve Additions(Bcf)					19,636	-0.8					19,288	-1.8
Reserve Replacement Ratio					104%						102%	
Total Recoverable Reserves (Bcf)					187,678	0.4					188,056	0.2
Reserve To Production Ratio(Years)					10.0						9.9	

Source: Historical Data, U.S. Department of Energy.

Note: May not sum to totals in all cases due to rounding.

(Information contained herein is believed to be reliable but its accuracy cannot be guaranteed. Past performance is not indicative of future results and the risk of loss is substantial in futures trading.

(a) Includes minor use as a fuel by Hess & Company, Inc. and W.H. Brown may, from time to time, have positions in the futures market relative to these recommendations.