



HORNSBY & COMPANY, INC.

www.hornsbyco.com

Energy Risk
Management Services

U.S. Natural Gas Perspectives Monthly Review and Outlook Summary

Over the past month the prompt NYMEX natural gas contract has risen about \$.20 per mmBtu on a point-to-point basis. Within the period, however, the contract reached a settlement high of \$8.353 per mmBtu in mid January in response to colder weather and a modest reduction in net short positions held by active managed commodity funds. Since that time, however, weaker oil prices have forced natural to retrace toward \$8.00 per mmBtu, also impacted by milder temperatures in primary gas-consuming regions. Overall, however, we remain encouraged by the ability to reduce working storage levels, and we still anticipate the U.S. natural gas balance to improve over time. Despite the periodic and inevitable concerns about either prolonged gas shortages or surpluses, the U.S. natural gas balance has exhibited a phenomenal ability to “self correct” over time, reflecting responses on both the demand and supply side of the equation, and we have witnessed such a development since working storage achieved all-time record levels last fall.

Our updated U.S. natural gas balances for 2008 suggest an even larger net draw in working storage for this year than previously forecast. This is despite the fact that we have trimmed our expectations for manufacturing growth and hence industrial sector natural gas demand for the first half of this year, although we still do not anticipate an “official” recession as defined as at least two consecutive quarters of negative real GDP growth. We believe the recent storage draws have at least in part reflected the impact of incremental residential gas hookups at the expense of heating oil as well as lower imports.

With regard to price, our Base Case now calls for a prompt NYMEX/Henry Hub average for 2008 of about \$7.95 per mmBtu. Although the current strip is suggesting a modestly higher average, we believe that if crude oil prices decline on a seasonal basis through the first quarter as we expect, natural gas prices will ease from current levels as well, but retain *relative* strength under the fundamental balance we envision.

+ U.S. natural gas consumption is forecast to increase by 2.1%, or some 485 bcf in 2008, an upward revision of about 85 bcf from our last report.

+ Domestic dry gas production is expected to rise by 0.4%, or about 75 bcf this year.

+ Our balances imply a net draw in working storage in 2008 of around 510 bcf, a larger draw than expected last month by some 190 bcf.

Viewpoint

Over the past month the prompt NYMEX natural gas contract has risen only about \$.20 per mmBtu on a point-to-point basis. This lies in contrast, however, to generally declining crude oil prices over the same period, and thus as we have been expecting, natural has firmed relative to oil.

Within the period, however, the prompt natural gas contract reached a settlement high of \$8.353 per mmBtu in mid January in response to colder weather and a modest reduction in net short positions held by active managed commodity funds.

We have emphasized in prior reports that active CFTC-reporting funds play less of a role in periodic short-term price determination than they do with crude oil, in part due to a smaller average percentage of open interest.

However, we in fact detect some influence recently due to the inordinate net short positions held by funds. For example, from December 24 when net short positions reached an all-time record high of 112,546 contracts, prices recovered and reached their mid-January peak when net short positions had been reduced to 94,117 contracts.

Since mid January, however, weaker oil prices have finally “forced” natural to retrace below \$8.00 per mmBtu, also impacted by milder temperatures in primary gas-consuming regions.

As we issue this report, the prospects of more seasonal temperatures in the Northeast along with a recovery in crude oil from around \$86.00 per barrel have led to the prompt contract trading above \$8.00 per mmBtu once again.

Fundamentally, we remain encouraged by the market’s ability to reduce working storage, and we still anticipate the U.S. natural gas balance to improve over time.

Despite the periodic and inevitable concerns about either prolonged gas shortages or surpluses over the past number of years, the U.S. natural gas balance has exhibited a phenomenal ability to “self correct” over time, reflecting responses on both the demand and supply side of the equation.

The short-term fuel switching capability when prices are low combined with the arrival of fewer spot LNG cargoes generally enables any excess storage levels to erode over time. We are now witnessing such a development ever since working storage achieved all-time record levels last fall.

Our updated U.S. natural gas balances for 2008 suggest an even larger net draw in working storage for this year than previously anticipated at some 510 bcf.

This is despite the fact that we have trimmed our expectations for manufacturing growth and hence industrial sector natural gas demand for the first half of this year. Right or wrong, however, we still do not anticipate an “official” recession as defined as at least two consecutive quarters of negative real GDP growth.

We believe the recent storage draws have at least in part reflected the impact of incremental residential gas hookups at the expense of heating oil as well as reduced LNG imports.

In terms of price, our Base Case now calls for a prompt NYMEX/Henry Hub average for 2008 of about \$7.95 per mmBtu, and as far as we can determine this outlook lies above current consensus expectations.

Although the current 2008 strip is suggesting a modestly higher average, we believe that if crude oil prices decline on a seasonal basis through the first quarter as we expect with WTI in March averaging around \$85.00 per barrel, NYMEX natural gas prices will ease from current levels as well, but retain *relative* strength under the fundamental balance we anticipate.

Demand: Review and Outlook

With both preliminary data through November and the latest DOE revisions now in hand, we estimate that 2007 U.S. natural gas consumption rose by 5.7%, or about 1.24 tcf, the strongest rate of growth thus far this decade, aided by a weather-induced recovery in the residential sector, strong electric utility demand, and growth by industrial consumers.

For 2008, however, assuming normal weather, we are looking for a slowdown in growth, but still relatively healthy for the natural gas market by historical standards.

We are all fully aware on a daily basis with regard to the risk of recession, with some economists assuming a downturn is now in hand. Based on recent trends in the manufacturing sector, we have trimmed our underlying growth assumption to little, if any, gain in the first half of the year compared to last year, but not negative.

Our customary table below illustrates the monthly output of the eight largest industrial gas consumers from the FRB. The latest data for December reveal a marked slowdown in chemical production versus the previous year, the largest single industrial gas consumer, with less pronounced weakening among all other industries with the exception of primary metals.

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

Industry	YOY %Chg. Output
Chemicals	+0.6
Petroleum and Coal	+0.2
Primary Metals	+8.0
Paper	-4.6
Food	+0.8
Non-Metallic Mineral	-1.6
Fabricated Metal	+1.8
Transportation Equip.	+0.8

Under our latest outlook industrial gas demand will decline by 0.5%, or some 30-35 bcf in 2008.

In line with moderating economic activity we would look for slower growth in gas demand by the electric utility sector, which we estimate this year will come in at +1.8%

Partially offsetting these impacts will be continued gains in the residential sector, aided by new gas hookups and/or conversions at the expense of heating oil. In this regard,

once January demand data are in hand we will be able to more precisely quantify this impact.

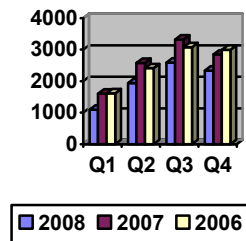
Putting all sectors together, we anticipate that U.S. natural gas consumption will increase by 2.1%, or around 485 bcf in 2008.

**Supply:
Review and Outlook**

On the supply side of the equation, we expect domestic dry gas production to rise by 0.4%, or about 75 bcf this year, a more moderate gain than the experience of 2007.

In terms of imports, we expect LNG cargoes to total above the 2007 level by some 50 bcf, less than what we perceive the consensus anticipates. An additional risk to our outlook is our assumption of a modest decline in pipeline imports from Canada. We fully, concede, however, that any moderation in volumes has yet to materialize.

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



Putting the demand and supply sides of the equation together, we now anticipate, despite a moderation in demand growth, a somewhat larger net draw in working storage than previously forecast.

At the end of the first quarter we are looking for storage to total about 1.1 tcf, implying an “underage” to the end of March 2007 of about 510 bcf, larger than the current deficit.

We note that many analysts are once again anticipating record storage levels come fall, but right or wrong our outlook would be more constructive. At the end of 2008 we

believe working storage will total about 2.3 tcf, suggesting a net draw for 2008 of about 510 bcf. If reasonable, it would place year-end storage about on par with the end of 2002.

Implications for Price

A number of press reports have highlighted many analysts' views that natural gas is severely overvalued, and that once winter ends prices are due for a collapse. Winter has not been terribly robust thus far, however, and thus we must be careful about assigning this seasonality to gas prices.

In fact, a look at the past few years reveals relatively little weakness from the first quarter to the second quarter price averages. This no doubt has been influenced by the tendency of crude oil prices to *rise* in the second quarter from the first, contrary to consensus expectations.

Granted, once industrial sector and storage demand "takes over" from winter heating consumption our more conservative view of manufacturing activity places some risk to this pattern.

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

1990-2007 Relationships	\$2.25(E)
1990-1999 Relationships	\$3.95(E)
2000-2007 Relationships	\$6.00(E)

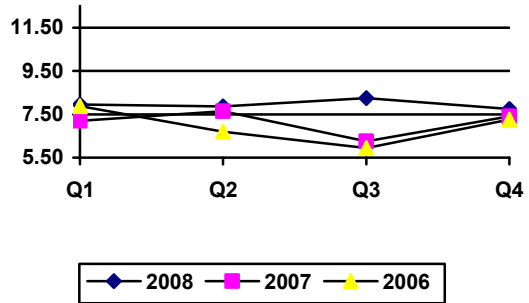
<u>2000-2007 Relationships</u>	
<u>Plus Oil Premium</u>	<u>\$7.90(E)(a)</u>

- a) @ 260 cents per gallon distillate and \$85.00 per barrel WTI.

Our customary table above in fact reveals that based purely on gas market fundamentals in isolation as reflected by relationships thus far this decade, March prompt NYMEX/Henry Hub "should" hit a target of only \$6.00 per mmBtu.

However, we cannot ignore oil, and assuming \$85.00 per barrel WTI, our models suggest a March target of \$7.90 per mmBtu.

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



For the third quarter, our balances in combination with our WTI outlook imply a modest recovery back above \$8.00 per mmBtu before easing once again in the fourth quarter. For 2008 as a whole, we forecast a prompt NYMEX/Henry Hub average of about \$7.95 per mmBtu, an upward revision of \$0.40 per mmBtu from our last report.

February 8, 2008

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

	Q1	Q2	Q3	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	4,709	4,832	4,839	18,971	2.7	4,609	4,728	4,851	4,858	19,047	0.4
Withdrawals From Storage	1,791	241	325	1,039	3,396	36.2	2,086	374	423	843	3,725	9.7
Supplemental Gaseous Fuels	18	14	15	15	63	-6.5	19	14	15	15	64	1.5
Imports	1,170	1,149	1,205	1,049	4,572	9.2	1,133	1,155	1,207	1,043	4,538	-0.7
Canada	967	853	965	950	3,736	4.1	948	836	946	931	3,661	-2.0
LNG	184	280	227	93	785		174	308	250	103	835	
Other	18	16	12	6	51		11	11	11	9	42	
Balancing Item	76	154	59	(473)	(185)		(50)	0	0	0	(50)	
Total Supply	7,646	6,267	6,436	6,469	26,817	6.1	7,797	6,270	6,497	6,759	27,323	1.9
Disposition												
Additions To Storage	328	1,209	1,063	582	3,182	8.7	331	1,221	1,074	588	3,214	1.0
Exports	203	171	198	195	766	5.8	180	185	185	205	755	-1.4
Consumption	7,115	4,887	5,175	5,692	22,869	5.7	7,286	4,864	5,238	5,966	23,354	2.1
Lease And Plant Fuel	278	286	294	292	1,150	2.4	277	284	291	291	1,143	-0.6
Pipeline and Distribution Use	192	132	140	142	606	3.5	152	151	155	160	619	2.2
Residential	2,320	761	347	1,297	4,725	8.2	2,463	735	350	1,422	4,971	5.2
Commercial(a)	1,262	564	377	811	3,014	6.4	1,341	540	375	899	3,155	4.7
Industrial	1,777	1,552	1,569	1,690	6,588	1.4	1,742	1,534	1,572	1,706	6,555	-0.5
Electric Power	1,286	1,592	2,448	1,460	6,786	9.1	1,310	1,621	2,494	1,487	6,911	1.8
Total Disposition	7,646	6,267	6,436	6,469	26,817	6.1	7,797	6,270	6,497	6,759	27,323	1.9
Addendum:												
Net Storage Injections	(1,463)	968	738	(457)	(214)		(1,755)	848	651	(255)	(511)	
End Period Working Gas In Storage	1,603	2,580	3,316	2,848	2,848		1,093	1,941	2,591	2,337	2,337	
Henry Hub Price (Dollars Per mmBtu)	7.20	7.64	6.25	7.41	7.12	2.6	7.95	7.87	8.25	7.75	7.96	11.7
Gas Wells Drilled					32,910	4.2					34,556	5.0
Total Discoveries(Bcf)					14,810	-6.2					13,822	-6.7
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)					18,810	-5.0					17,822	-5.2
Reserve Replacement Ratio					99%						94%	
Total Recoverable Reserves (Bcf)					186,792	-0.1					185,568	-0.7
Reserve To Production Ratio(Years)					9.8						9.7	

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

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

(E) WHB Energy Research LLC estimates.

(a) Includes minor use as vehicle fuel.

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.

Hornsby & Company, Inc. and W.H. Brown may, from time to time, have positions in the futures market relative to these recommendations.