



HORNSBY & COMPANY, INC.

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Energy Risk
Management Services

U.S. Natural Gas Perspectives Monthly Review and Outlook

Summary

Over the last month the prompt NYMEX natural contract is roughly unchanged on a point-to-point basis. Within the period, however, the contract managed to hit a settlement low of \$3.684 per mmBtu on March 18 before recovering. A progressive rise in oil prices in the final analysis simply could not leave natural gas behind indefinitely. From a fundamental standpoint, traders had been reluctant to buy given the rise in working storage levels versus the previous year reflecting moderate temperatures and sagging manufacturing activity. Eventually, however, low prices gave way to further temporary fuel switching, but more importantly the realization that drilling activity and production levels were either declining already or, even in the case of robust shale gas output, would do so down the road. From the lows of mid March, prompt NYMEX natural managed to recover to over \$4.30 per mmBtu.

As we issue this report, however, prices have retraced back below \$4.00 per mmBtu in response to the most recent working storage data which revealed a build as opposed to an expected draw for the week ending March 20. In our view the reaction has been overdone, and reflects the typical volatility this time of year when the balance transitions from the seasonal draw in storage to the beginnings of the normal build. In any event, updating our balances still suggests a progressive improvement in the gas balance in the second half of 2009, induced by our assumed stabilization in manufacturing output in tandem with reduced import levels and an actual decline in domestic dry gas production. As previously discussed, however, even *our* numbers suggest the year-over-year storage excess will get worse before it improves. Our balances would imply the timing for the inflection point will come later in the second quarter. In terms of price, we have made a modest adjustment to our forecast prompt NYMEX/Henry Hub average for this year, primarily reflecting the weakness in March which exceeded our expectations. We now expect natural to average about \$5.85 per mmBtu this year, a downward revision of less than 15 cents from our last report.

+ U.S. natural gas demand is expected to decline by 2.1%, or 485 bcf this year.

+ Domestic production is forecast to decline by 1.3%, or 260 bcf in 2009.

+ Our balance implies a net build in working storage of 130 bcf, less than previously forecast.

Viewpoint

Since the publication of our last monthly report the prompt NYMEX natural contract is roughly unchanged on a point-to-point basis at less than \$4.00 per mmBtu.

Within this time period, however, the contract weakened and managed to fall to a settlement low of \$3.684 per mmBtu on March 18 before subsequently recovering.

During this period, the prompt NYMEX crude oil contract rose in excess of \$10.00 per barrel despite bloated crude oil inventories, reflecting increased optimism towards the U.S. economy and a weaker dollar. In the final analysis, a progressive rise in WTI simply could not leave natural gas behind indefinitely.

From a fundamental standpoint, gas traders had been reluctant to buy given the progressive rise in working storage compared to the previous year, reflecting moderate late winter temperatures and sagging manufacturing activity.

Eventually, however, low gas prices gave way to further, albeit temporary fuel switching, including short-term coal displacement in select markets.

Perhaps more importantly, however, there is now the realization that drilling activity and production levels were either declining already or, even in the case of robust shale gas output, would do so down the road.

As a result, from the lows of mid March prompt NYMEX natural managed to recently recover to over \$4.30 per mmBtu.

As we issue this report, however, prices have retraced back below \$4.00 per mmBtu in response to the latest weekly working storage data revealing a build as opposed to an expected draw for the week ending March 20.

In our view the market response to the data has been overdone, reflecting typical volatility this time of year when the balance transitions from the seasonal draw in storage to the beginnings of the customary build. The precise timing is uncertain, and therefore the potential deviation from expectations can be substantial.

In any event, updating our Base Case natural gas balances still implies a progressive improvement in the gas balance in the second

half of 2009 as a result of our assumed stabilization in manufacturing output in combination with reduced import levels and an actual decline in domestic dry gas production.

As previously discussed, however, even our numbers suggest the year-over-year storage excess will get worse before it improves, but our balances suggest that the timing for the inflection point will come in May.

In terms of price, we have made a modest adjustment to our forecast prompt NYMEX/Henry Hub average for this year, primarily reflecting the weakness in March which exceeded our expectations.

We now expect natural to average about \$5.85 per mmBtu this year, a downward revision of less than 15 cents from our last report.

Demand: Review and Outlook

The latest DOE numbers complete the demand picture for 2008, at least on a preliminary basis. Total U.S. natural gas consumption increased by 0.8%, or some 190 bcf in 2008 versus the prior year, with first quarter gains in the residential and commercial sectors largely offsetting the progressive erosion in industrial and electric utility sector demand as the recession intensified.

As we are all aware, industrial production deteriorated as the fourth quarter progressed, with further weakness carrying over into 2009. The latest data from the Federal Reserve Board reveal that in February aggregate manufacturing activity dropped by 13.1% versus February of 2008.

Our customary table illustrated below demonstrates that output by the eight largest consumers of natural gas remains weak, but overall did not deteriorate materially from the previous year relative to the January comparisons.

While the consensus is reluctant to suggest that the bottom in industrial production has finally arrived, our Base Case has in fact assumed that the decline in manufacturing activity versus last year will begin to stabilize, with less onerous comparisons evident by the third quarter.

To quantify, for the third quarter as a whole our demand outlook assumes that manufacturing output will be roughly flat with the prior year. We fully recognize that we remain an “outlier” in this regard, but we remain convinced that our outlook is reasonable.

**Eight Largest Industrial Consumers
Of Natural Gas
February Manufacturing Output**

Industry	YOY %Chg. Output
Chemicals	-11.3
Petroleum and Coal	-2.7
Primary Metals	-40.5
Paper	-15.3
Food	-2.5
Non-Metallic Mineral	-17.2
Fabricated Metal	-15.8
Transportation Equip.	-23.8

As such, we believe that industrial gas demand will decline by “only” 4.3%, or some 285 bcf this year, with the fourth quarter registering a positive comparison to the fourth quarter of 2008.

Assuming normal summer and fourth quarter weather, we expect total U.S. natural gas consumption to decline by 2.1%, or about 485 bcf this year, with all primary sectors registering declines versus 2008 for the year as a whole. This marks a downward revision from last month’s report by only some 60 bcf.

**Supply:
Review and Outlook**

The variable that we have in fact revised to a greater degree has been domestic production. Following updated statistics on drilling activity and current output, anecdotal evidence, and discussions with some producers, we have trimmed our expectations for 2009, particularly in the second half of the year.

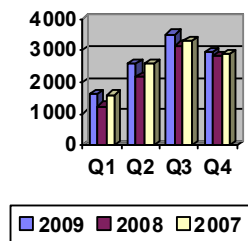
We now believe that for 2009 as a whole domestic dry gas production from all

sources will decline by 1.3%, or about 260 bcf from last year, a downward revision from last month’s report by more than 300 bcf. Our latest estimate would also include the impact of shut ins announced by various companies.

Perhaps we have taken it too far, but severely weak Henry Hub prices and even lower prices in various other regions of the country suggest we may be reasonable in our latest assessment.

We have also trimmed anticipated levels of LNG imports from last month, although to a much smaller degree due to adverse spot cargo economics relative to other consuming regions such as Europe and Asia.

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



Putting it all together, our updated balances now suggest that for 2009 as a whole, we expect a net build in working storage of around 130 bcf, some 235 bcf less than forecast in our previous report, and due almost exclusively to lower production assumptions.

However, as previously discussed our balances imply that the working storage “overage” compared to last year will rise further before stabilizing. To quantify, our latest balances peg the peak versus 2008 in May at about 445 bcf. This compares to the “overage” for the week ending March 20 of 372 bcf.

From May onward, however, our reduced production assumptions begin to “bite” into the balance, and assuming that manufacturing activity finally stabilizes in the second half of the year, the overage will erode. At end-2009, our balances suggest that working storage will stand at a bit less than 3.0 tcf,

placing year-end levels modestly below the end of 2006.

Implications for Price

As previously discussed, as we issue this report a bearish storage report has managed to pull prompt NYMEX natural back below \$4.00 per mmBtu.

In addition, equity markets are retracing part of their recent gains as we near the end of the first quarter, pulling crude oil down as well. A recovery in the dollar is also weakening WTI, likely impacting natural in sympathy.

There are a number of gas analysts who still believe that prompt NYMEX natural can fall to \$2.50 per mmBtu by summer. Gas has already traded at this level in select regions other than Henry Hub. We of course cannot guarantee that prices will not fall to these levels.

However, to the extent that natural cannot be *completely* de-linked from crude oil, our Base Case crude oil price forecast made in January has been quite close to the mark for March, and potentially April.

In fact, prompt WTI is now trading above our expectations for the average for calendar April, and as we issue this report the market is “backing and filling” as we anticipated that it would.

Henry Hub Price Outlook Average for Month of June 2009 (\$/mmBtu)

1990-2008 Relationships	\$3.10(E)
1990-1999 Relationships	\$1.45(E)
2000-2008 Relationships	\$5.00(E)

<u>2000-2008 Relationships</u>	
<u>Plus Oil Premium</u>	<u>\$5.40(E)(a)</u>

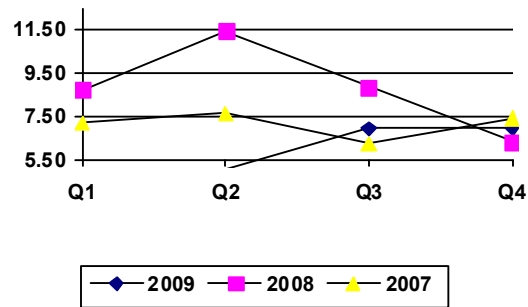
- a) @ 160 cents per gallon distillate and \$55.00 per barrel WTI.

Having said this of course, prompt WTI *could* trade back below \$50.00 per barrel and if OPEC compliance “loosens” and demand shows no signs of recovering, a move back below \$40.00 per barrel cannot be ruled out.

However, we feel we must retain our convictions, and if we are correct that following this “backing and filling” WTI resumes a modest upward trend, then natural should begin to stabilize once again at its Mid-March lows.

If so, then we believe, as illustrated above, that our June target of \$5.40 per mmBtu is achievable even if the year-over-year storage “overage” continues to expand until May as expected.

**Henry Hub Prices
2007-2009
(Dollars per MCF)**



In the second half of the year, if our balance as previously discussed unfolds, then further gains for natural gas prices are likely. For 2009 as a whole, we expect prompt NYMEX/Henry Hub to average about \$5.85 per mmBtu, a downward revision from last month by less than \$0.15 per mmBtu.

March 27, 2009

U.S. Natural Gas Supply and Demand Balances
2008-2009
(Billion Cubic Feet)

	Q1	Q2	Q3	Q4	2008	%Chg 08-07	Q1(E)	Q2(E)	Q3(E)	Q4(E)	2009(E)	%Chg 09-08
Supply												
Total Dry Gas Production	5,080	5,128	5,108	5,254	20,570	7.8	5,165	5,077	4,973	5,096	20,311	-1.3
Withdrawals From Storage	1,891	242	277	957	3,367	1.3	1,451	228	378	1,183	3,240	-3.8
Supplemental Gaseous Fuels	11	14	14	16	56	-11.2	11	15	14	16	56	1.4
Imports	1,096	902	959	1,020	3,976	-13.6	1,101	886	942	1,013	3,942	-0.9
Canada	1,017	798	846	920	3,581	-5.2	1,018	797	845	919	3,579	-0.1
LNG	76	97	98	81	352		77	79	86	85	327	
Other	3	7	14	19	43		6	9	11	9	36	
Balancing Item	(29)	111	(27)	(490)	(435)		(7)	(50)	0	(485)	(542)	
Total Supply	8,049	6,397	6,331	6,757	27,533	2.1	7,721	6,154	6,308	6,823	27,006	-1.9
Disposition												
Additions To Storage	255	1,173	1,270	638	3,336	6.5	258	1,185	1,283	644	3,369	1.0
Exports	324	215	193	254	985	19.8	317	202	185	205	909	-7.7
Consumption	7,470	5,009	4,868	5,865	23,212	0.8	7,147	4,768	4,840	5,974	22,728	-2.1
Lease And Plant Fuel	317	321	319	328	1,285	7.2	310	305	298	306	1,219	-5.2
Pipeline and Distribution Use	202	136	132	158	628	1.1	163	160	159	168	650	3.5
Residential	2,356	775	347	1,401	4,879	3.4	2,365	694	350	1,415	4,825	-1.1
Commercial(a)	1,302	569	382	873	3,126	3.6	1,286	497	380	869	3,032	-3.0
Industrial	1,871	1,607	1,538	1,628	6,644	0.3	1,629	1,543	1,512	1,676	6,360	-4.3
Electric Power	1,422	1,601	2,150	1,477	6,650	-2.8	1,394	1,569	2,141	1,540	6,643	-0.1
Total Disposition	8,049	6,397	6,331	6,757	27,533	2.1	7,721	6,154	6,308	6,823	27,006	-1.9
Addendum:												
Net Storage Injections	(1,636)	931	993	(319)	(31)		(1,193)	957	904	(539)	129	
End Period Working Gas In Storage	1,247	2,171	3,163	2,840	2,840		1,647	2,604	3,508	2,969	2,969	
Henry Hub Price (Dollars Per mmBtu)	8.74	11.46	8.86	6.32	8.85	24.2	4.50	5.08	6.95	6.95	5.87	-33.6
Gas Wells Drilled					33,733	2.5					21,926	-35.0
Total Discoveries(Bcf)					14,168	-4.3					8,551	-39.6
Discoveries Per Well(Bcf)					0.42	-6.7					0.39	-7.1
Total Revisions and Adjustments(Bcf)					4,000	0.0					4,000	0.0
Total Reserve Additions(Bcf)					18,168	-3.4					12,551	-30.9
Reserve Replacement Ratio					88%						62%	
Total Recoverable Reserves (Bcf)					184,246	-1.3					176,486	-4.2
Reserve To Production Ratio(Years)					9.0						8.7	

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.

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