



HORNSBY & COMPANY, INC.

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Energy Risk
Management Services

U.S. Natural Gas Perspectives Monthly Review and Outlook

Summary

The prompt NYMEX natural contract recently traded at its highest level since January 2006, but has gained by only \$0.20 per mmBtu on a point-to-point basis since our last report. Over the past month, the contract had declined to a settlement low of around \$9.00 per mmBtu, but lofty crude oil prices combined with early spring cool weather led to a recovery back toward \$10.00 per mmBtu. The most recent surge has reflected a response to word that deliveries from the Independence Hub in the Gulf of Mexico have been halted due to a pipeline leak, with repairs slated to take one to four weeks. Independence has a capacity of some 1 BCF/D, with recent deliveries averaging about 900 MMCF/D. At pre-disruption rates, a four-week hiatus would therefore imply a total loss of some 25.2 billion cubic feet. To be conservative in light of current prices, our current Base Case has incorporated a loss of this magnitude for roughly the month of April.

Embracing this assumption, our updated balances still imply a somewhat smaller forecast net storage draw for 2008 as a whole compared to our previous assessment. Domestic dry gas production appears to be somewhat stronger than we have assumed, and we have revised up our expectations for Canadian pipeline deliveries, which more than offset a marginally stronger demand estimate for this year, primarily for the first quarter. Our economic assumptions have not been revised, and we have still not incorporated an "official" recession as technically defined. Having said this, however, we remain conservative with regard to our outlook for manufacturing activity through the remainder of 2008.

In terms of price, we have revised up our forecast prompt NYMEX/Henry Hub for this year by some \$0.35 per mmBtu to around \$8.60 per mmBtu, assuming that eventually WTI breaks below \$100.00 per barrel once again, but probably not until the second half of the year.

+ We anticipate domestic dry gas production will increase by 1.1%, or about 215 bcf this year, an upward revision from last month by some 320 bcf.

+ U.S. natural gas consumption is expected to rise by 2.6%, or around 610 bcf in 2008, higher than last month's outlook by about 165 bcf.

+ Our balances now imply a draw in working storage for 2008 of some 210 bcf, less than forecast last month by 175 bcf.

Viewpoint

A few days ago, the prompt NYMEX natural gas contract managed to reach its highest level since January 2006 in the aftermath of hurricanes Katrina and Rita, but has risen by only \$0.20 per mmBtu on purely a point-to-point basis since our last report.

Over the past month, however, the contract declined to a settlement low of around \$9.00 per mmBtu, but with WTI finding a bottom at \$100.00 per barrel, recovering crude oil prices combined with periodic early spring cool weather led to a progressive rise back toward \$10.00 per mmBtu.

The behavior of active CFTC-reporting funds has helped support price behavior. While still net short by a large margin, since our last report such funds have reduced their futures-only net short positions by some 10,000 contracts.

The most recent surge in price has reflected a response to word that deliveries from Enterprise Products Partners' Independence Hub in the Gulf of Mexico have been halted due to a pipeline leak, with repairs slated to take one to four weeks as we issue this report.

Independence has a capacity of some 1 BCF/D, with pre-disruption deliveries averaging about 900 MMCF/D. Thus, a four-week hiatus for repairs, if necessary, would therefore imply a total loss of some 25.2 billion cubic feet.

We believe that in light of current price levels it pays to be conservative. As such, our current Base Case has now incorporated a loss of this magnitude for roughly the month of April.

Embracing this assumption, right or wrong, our updated balances would still imply a somewhat smaller forecast net storage draw for 2008 as a whole compared to our previous assessment. On balance, however, our outlook remains relatively constructive.

Impacting our updated balances is the fact that domestic dry gas production has been somewhat stronger than we had assumed thus far in 2008.

We have also revised up our expectations for Canadian pipeline deliveries, which more than offset a fine tuning down of our LNG import assumptions. Higher supply more than offsets a marginally stronger demand

estimate for this year, primarily for the first quarter.

Our macroeconomic outlook has not been revised. As such, we have still not assumed an "official" recession as technically defined as at least two consecutive quarters of negative real GDP growth.

Having said this, however, we remain quite conservative with regard to our outlook for manufacturing activity through the remainder of 2008.

With regard to price, we have revised up our forecast prompt NYMEX/Henry Hub estimate for this year by some \$0.35 per mmBtu to around \$8.60 per mmBtu, assuming that eventually WTI breaks below \$100.00 per barrel once again.

Demand: Review and Outlook

The DOE, in a rare move, did not materially revise 2007 demand estimates in their latest Natural Gas Monthly. Although only preliminary January data are available at this time, the residential numbers appear to confirm one of our core assumptions in expecting an improving natural gas balance.

We have previously discussed our belief, based both on data and anecdotal evidence, that residential sector gas demand would be boosted in winter reflecting conversions and new hookups at the expense of heating oil.

January residential demand data, although once again subject to revision, suggest that consumption per heating degree day rose by almost 3.4% compared to January 2007.

January industrial gas demand per unit of manufacturing output rose as well compared to the prior year reflecting preferential pricing at the time. However, given the recovery in natural gas prices since January we do not believe it is reasonable to extrapolate this phenomenon through the remainder of 2008.

In terms of the economy, we continue to assume a "flattish" picture for manufacturing activity until the second half of the year, when we assume the beginnings of a 2.0% year-over-year rate of growth.

Our customary manufacturing output table for the eight largest industrial consumers of natural gas laid out below reveals a mixed picture for February, but implies net positive industrial gas demand growth nonetheless.

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

| Industry | YOY %Chg. Output |
|------------------------------|-----------------------------|
| Chemicals | +0.5 |
| Petroleum and Coal | +2.3 |
| Primary Metals | +5.4 |
| Paper | -0.5 |
| Food | +1.2 |
| Non-Metallic Mineral | +0.3 |
| Fabricated Metal | +2.2 |
| Transportation Equip. | +1.1 |

Taking our economic outlook in tandem with our assumption of normal summer and fourth quarter weather, we expect U.S. natural gas demand to gain by 2.6%, or about 610 bcf this year, an upward revision from last month's report by some 115 bcf.

Within this outlook residential demand is pegged to gain by 6.9%, commercial demand to rise by 6.4%, industrial consumption to fall by 0.6%, with electric utility demand to increase by 1.5%. We would emphasize, however, that about 55% of our expected aggregate demand gain for 2008 occurred in the first quarter.

**Supply:
Review and Outlook**

While in its latest data update the DOE did not make any material revisions to demand for 2007, there *were* monthly upward revisions to domestic dry gas production survey responses. The DOE now estimates that 2007 natural gas production rose by 4.3%, or some 800 bcf, exceeding even the 4.0% rise registered back in 1994.

We have revised up our outlook for this year, but as previously discussed have tempered

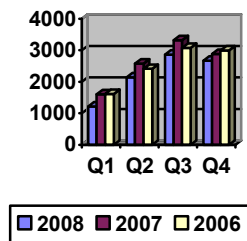
deliveries under the conservative assumption that Independence Hub will be offline for four weeks, removing some 25.2 bcf from the month of April.

Incorporating this assumption, however, we are still looking for dry gas production to increase by 1.1%, or around 215 bcf this year. If we are off the mark, we believe we will likely end up on the conservative side of actual domestic gas production based on early-2008 trends.

On the import front, we have revised up our outlook for Canadian pipeline deliveries for this year, but trimmed slightly our LNG assumptions. The net result, however, is an overall modest upward revision to U.S. net natural gas imports.

Putting together our demand and supply assumptions, we have reduced our forecast net working storage draw for 2008 to about 210 bcf, a cut from last month by 175 bcf. At the end of the second quarter we believe that working storage will total a bit over 2.1 tcf, below end-June 2007 levels by a full 440 bcf, obviously influenced by our Independence Hub assumptions.

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



Thereafter, however, our forecast year-over-year deficit progressively declines, reaching our 210-odd bcf level at the end of 2008. If our outlook is reasonable, it would imply year-end storage about on par with the end of 2005.

Implications for Price

With the ultimate price impact of the Independence Hub disruption yet to be determined, it behooves us to take another look

at our June (basis July) NYMEX price target of \$9.10 per mmBtu.

When we incorporate our current end-second quarter storage assumptions, it would imply, all else equal, a lower target by some \$0.45 per mmBtu. However, as we have always maintained, our “oil premium” will largely outweigh almost any revision to storage assumptions.

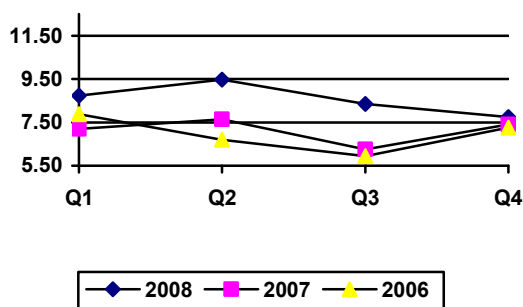
In this regard, we have discussed in other reports our work in progress toward finalizing a crude oil price forecasting system that incorporates both financial and fundamental variables, as we progress through our post-2003 world.

In our morning market note of April 10, we provided an update of the current level of our model output under certain June assumptions for the dollar/euro rate, Fed funds rate, days supply of crude oil, term structure and CFTC active fund net position. Combining the variables yielded a June target of \$109.00 per barrel.

leaning toward more rate cuts at the end-April meeting.

As such, the net result is an upward revision to our June target by \$0.40 per mmBtu to \$9.50 per mmBtu. For 2008 as a whole, we are now anticipating a prompt NYMEX/Henry Hub average of around \$8.60 per mmBtu, an upward revision from last month by some \$0.35 per mmBtu.

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



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

| | |
|--------------------------------|------------------|
| 1990-2007 Relationships | \$3.45(E) |
| 1990-1999 Relationships | \$1.85(E) |
| 2000-2007 Relationships | \$5.15(E) |

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**2000-2007 Relationships
Plus Oil Premium **\$9.50(E)(a)****

- a) @ 285 cents per gallon distillate and \$100.00 per barrel WTI.**

Our most important point, however, was that unless the crude oil/dollar trade is broken, prompt WTI would have difficulty settling below \$100.00 per barrel, almost irrespective of underlying fundamentals.

As such, our customary table above, while incorporating our somewhat less constructive end-June balance assumptions compared to last month, also assumes a \$100.00 per barrel value for WTI, some \$6.00 per barrel higher than forecast last month. We do not see anything imminent that would lead to a dramatic strengthening in the dollar, assuming the Fed is

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

| | Q1 | Q2 | Q3 | Q4 | 2007 | %Chg 07-06 | Q1(E) | Q2(E) | Q3(E) | Q4(E) | 2008(E) | %Chg 08-07 |
|--|-------------|-------------|-------------|-------------|-------------|---------------|-------------|-------------|-------------|-------------|-------------|---------------|
| Supply | | | | | | | | | | | | |
| Total Dry Gas Production | 4,633 | 4,757 | 4,882 | 5,005 | 19,277 | 4.3 | 4,768 | 4,779 | 4,915 | 5,030 | 19,492 | 1.1 |
| Withdrawals From Storage | 1,791 | 241 | 325 | 964 | 3,321 | 33.2 | 2,001 | 304 | 351 | 742 | 3,398 | 2.3 |
| Supplemental Gaseous Fuels | 18 | 14 | 15 | 13 | 61 | -9.6 | 9 | 14 | 15 | 13 | 52 | -14.3 |
| Imports | 1,170 | 1,149 | 1,205 | 1,078 | 4,602 | 9.9 | 1,159 | 1,153 | 1,212 | 1,080 | 4,603 | 0.0 |
| Canada | 967 | 853 | 965 | 991 | 3,777 | 5.2 | 987 | 858 | 966 | 990 | 3,801 | 0.6 |
| LNG | 184 | 280 | 227 | 79 | 771 | | 161 | 284 | 234 | 82 | 761 | |
| Other | 18 | 16 | 12 | 9 | 54 | | 11 | 11 | 11 | 9 | 42 | |
| Balancing Item | 37 | 109 | 12 | (431) | (273) | | 57 | 0 | 0 | 0 | 57 | |
| Total Supply | 7,649 | 6,270 | 6,439 | 6,630 | 26,987 | 6.8 | 7,994 | 6,250 | 6,492 | 6,866 | 27,602 | 2.3 |
| Disposition | | | | | | | | | | | | |
| Additions To Storage | 328 | 1,209 | 1,063 | 546 | 3,146 | 7.5 | 343 | 1,221 | 1,074 | 551 | 3,189 | 1.4 |
| Exports | 203 | 171 | 198 | 238 | 809 | 11.7 | 198 | 185 | 185 | 205 | 773 | -4.5 |
| Consumption | 7,118 | 4,890 | 5,178 | 5,846 | 23,032 | 6.5 | 7,454 | 4,844 | 5,234 | 6,109 | 23,640 | 2.6 |
| Lease And Plant Fuel | 281 | 289 | 297 | 303 | 1,170 | 4.2 | 287 | 287 | 295 | 302 | 1,171 | 0.1 |
| Pipeline and Distribution Use | 192 | 132 | 140 | 159 | 623 | 6.5 | 172 | 153 | 157 | 166 | 648 | 4.1 |
| Residential | 2,320 | 761 | 347 | 1,296 | 4,724 | 8.2 | 2,542 | 735 | 350 | 1,421 | 5,048 | 6.9 |
| Commercial(a) | 1,262 | 564 | 377 | 806 | 3,009 | 6.2 | 1,392 | 540 | 375 | 893 | 3,200 | 6.4 |
| Industrial | 1,777 | 1,552 | 1,569 | 1,735 | 6,633 | 2.1 | 1,772 | 1,508 | 1,562 | 1,752 | 6,595 | -0.6 |
| Electric Power | 1,286 | 1,592 | 2,448 | 1,547 | 6,873 | 10.5 | 1,288 | 1,621 | 2,494 | 1,575 | 6,978 | 1.5 |
| Total Disposition | 7,649 | 6,270 | 6,439 | 6,630 | 26,987 | 6.8 | 7,994 | 6,250 | 6,492 | 6,866 | 27,602 | 2.3 |
| Addendum: | | | | | | | | | | | | |
| Net Storage Injections | (1,463) | 968 | 738 | (418) | (175) | | (1,658) | 917 | 723 | (191) | (209) | |
| End Period Working Gas In Storage | 1,603 | 2,580 | 3,316 | 2,879 | 2,879 | | 1,221 | 2,138 | 2,861 | 2,670 | 2,670 | |
| Henry Hub Price (Dollars Per mmBtu) | 7.20 | 7.64 | 6.25 | 7.41 | 7.12 | 2.6 | 8.74 | 9.47 | 8.35 | 7.75 | 8.58 | 20.4 |
| 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 | | | | | 98% | | | | | | 91% | |
| Total Recoverable Reserves (Bcf) | | | | | 186,486 | -0.3 | | | | | 184,816 | -0.9 |
| Reserve To Production Ratio(Years) | | | | | 9.7 | | | | | | 9.5 | |

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

Notation: (E) Estimated. Total supply and demand balances are in billions of cubic feet. Past performance is not indicative of future results and the risk of loss is substantial in futures markets. (E) WHB Energy Research, Inc. and W.H. Brown may, from time to time, have positions in the futures market relative to these recommendations. (a) Includes minor use as vehicle fuel.