



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 natural gas report, the prompt NYMEX natural contract has risen by about \$1.35 per mmBtu. Although the natural gas balance has improved from the bearish prognostications of last autumn, the primary catalyst has been the concurrent \$15.00 per barrel rise in prompt WTI. Crude oil's surge has developed through a combination of a failure of the dollar to strengthen materially "post-Fed", concerns over Nigerian production disruptions, and worries that a U.S. strike against Iran may be launched in the next few months. Crude oil has also been supported fundamentally by *relative* tightness in world distillate markets given non-OECD mid-barrel demand growth in combination with prolonged OECD refinery turnarounds. Overall, however, crude remains the commodity of choice, with funds seeing that there is absolutely no indication that the U.S. or any other government will try to intervene in some manner to try and put the breaks on rising oil prices.

With regard to natural gas specifically, we have made relatively little revision to our forecast balances for the remainder of 2008. On the supply side, robust domestic production gains relative to the trend of the last several years are at least partially offset by lower LNG imports. On the demand side, as we anticipated the first quarter was supported by conversions from heating oil by residential consumers, offsetting incremental conservation overall. In addition, we observed short-term, price-induced switching by industrial and electric utility consumers.

In terms of price, given our Base Case forecast average for WTI in 2008 of about \$101.00 per barrel, we are compelled to revise up modestly our expected prompt NYMEX/Henry Hub average for this year. In terms of progression, as with crude oil we expect a relatively high second quarter average to be followed by a subsequent weakening as we move toward the end of 2008. Overall, we are looking for an annual average of about \$9.05 per mmBtu, an upward revision from last month's report by some \$.65 per mmBtu.

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- + U.S. natural gas consumption is expected to increase by 2.7%, or about 610 bcf this year.
 - + Domestic dry gas production is forecast to rise by 3.7% or some 715 bcf in 2008.
 - + Our balances imply a net storage draw of around 190 bcf this year, less than last month by 20 bcf.
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Viewpoint

Since the publication of our last monthly natural gas report, the prompt NYMEX natural gas contract has risen by about \$1.35 per mmBtu to its current level of around \$11.40 per mmBtu. Contributing to the price gain has been a tendency of CFTC-reporting funds to reduce, on average, their substantial net short positions.

Although the natural gas balance has clearly improved from the bearish forecasts of last autumn when record working storage levels were achieved, the primary price catalyst has been the \$15.00 per barrel rise in prompt WTI that has occurred over the past month.

Crude oil's price gain has evolved as a result of the failure of the dollar to strengthen further following the latest meeting of the Federal Reserve. In addition, however, concerns over Nigerian production disruptions and worries that a U.S. military strike against Iran is inevitable have fueled the surge as well.

Crude oil prices have also been supported fundamentally by *relative* tightness in world distillate markets given non-OECD mid barrel demand growth, and we had discussed back in January the potential impact of incremental diesel demand in China this year. The demand effect has been compounded over the past month by prolonged OECD refinery turnarounds.

In general, however, crude remains the commodity of choice given the potential for "excess returns" given any potential supply problem. Hedge and other funds also fully realize, correctly as we have discussed, that there is absolutely no indication that the United States or any other government will intervene in some manner to try and reverse the rising trend.

With regard to natural gas specifically, we have made relatively little revision to our forecast balances for the remainder of 2008 which has remained on the constructive side despite the burden of record working storage last fall.

When we review the supply side, robust domestic production gains relative to the trend of the last several years are at least partially offset by lower LNG imports due to more attractive laid-in pricing for spot cargoes in most other markets.

On the demand side, as we anticipated the first quarter was supported by conversions from heating oil in the residential sector, which appeared to offset incremental conservation by existing natural gas customers.

In addition, we observed during the period short-term price-induced switching by industrial and electric utility consumers, leading to higher natural gas demand per unit of manufacturing output and in turn a substantial decline in heavy fuel oil demand in the first quarter.

With regard to price, as discussed in our last World Petroleum Perspectives, our Base Case calls for a 2008 average for WTI of about \$101.00 per barrel. As a result, we are compelled to revise up modestly our expected prompt NYMEX/Henry Hub average for this year.

In terms of quarterly progression, as with crude oil we expect a relatively high second quarter average, to be followed by a weakening trend as we move toward the end of the year.

Overall, we expect a 2008 average of about \$9.05 per mmBtu, an upward revision from last month's expectations by some \$.65 per mmBtu.

Demand: Review and Outlook

Once again we have all been blessed by little revision by the DOE to historical demand data as published in their latest Natural Gas Monthly. Looking at preliminary estimates in the residential sector for January and February, the numbers in fact confirm our suspicion and anecdotal evidence that lofty heating oil prices induced some consumers to switch to natural gas where possible.

As we have discussed in recent reports, February DOE oil data reveal that heating oil demand virtually collapsed even adjusting for fewer heating degree days compared to the prior year, and clearly natural gas as well as conservation by oil "burners" accounted for the results.

Looking at the industrial sector, the early-2008 demand data suggest stable to a modest gain in consumption per unit of *total* manufacturing output. While this is partly due

to more favorable pricing relative to oil at the time in select markets, our customary table below reveals that relative to U.S. manufacturing as a whole the output of metals and food companies was more robust in March, helping to offset weakness in other industries.

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

Industry	YOY %Chg. Output
Chemicals	+0.6
Petroleum and Coal	-1.2
Primary Metals	+2.6
Paper	-1.9
Food	+2.0
Non-Metallic Mineral	-0.3
Fabricated Metal	+2.4
Transportation Equip.	-2.6

At this point we retain our long-standing Base Case assumption that although gains in manufacturing output for the remainder of 2008 are expected to be modest and roughly in line with the March rise of 1.2% versus the previous year, we have not assumed a recession as technically defined.

As such, for 2008 we estimate that industrial sector natural gas demand will rise by 0.5%, or some 30 bcf versus last year, a moderation from the estimated 2.2% annual gain experienced in 2007.

With regard to the electric utility sector, we have assumed normal cooling degree days in the months ahead, and the demand outlook will reflect a moderation in economic activity combined with incremental conservation limiting overall generation growth. As such, we anticipate a rise in demand this year for this sector of 1.7%, or some 120 bcf over 2007.

Putting all consumption sectors together, we are looking for a rise in total U.S. natural gas demand this year of 2.7%, or about 610 bcf, about unchanged from last month's assessment.

**Supply:
Review and Outlook**

There is now emerging some discussion about the prospects for pre-winter working storage recovering to record levels. The arguments revolve around the fact that domestic gas production is obviously on the rise due to healthy gains in the deepwater Gulf of Mexico and projects such as Barnett Shale.

As such, if the U.S. economy deteriorates further over the summer, industrial demand will be even weaker, more than offsetting any potential prolonged heat waves and/or interruptions from yet-to-be-determined hurricane activity.

There is no question that domestic gas production has recovered over the past year, rising by an estimated 4.3% in 2007. Thus far in 2008, DOE data reveal a continued healthy trend.

We estimate that domestic dry gas production will increase by 3.7%, or some 715 bcf this year and, as previously discussed, we fully concede we could end up too conservative. We believe, however, that as we approach the end of 2008 gains in deepwater GOM and shale will be partially offset by accelerated depletion in conventional onshore fields.

At the same time, clearly LNG imports will be lower this year due to preferential pricing in other countries more closely linked with oil, attracting incremental cargoes away from the U.S.

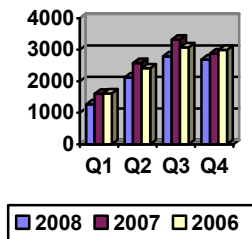
This marks a stark reversal from consensus expectations of only a year or so ago, when many consultants were predicting a bearish long-term natural gas balance due to an incessant flood of LNG.

Gross natural gas imports from all sources rose by 9.9% last year. For 2008 we estimate that total imports will fall by 8.9%, or some 410 bcf. Exports are likely to increase over 2007.

As such, despite rising domestic production, as long as industrial gas demand does not come in materially weaker than we expect, our balances suggest a net draw in working storage for 2008 of about 190 bcf, only 20 bcf less than we expected last month. If reasonable, it would imply beginning the 2008-2009 heating season with storage standing at

around 3.0 tcf, short of last year's pre-season record.

End-Quarter Working Gas Storage Levels (BCF)



Implications for Price

Almost irrespective of the fundamental natural gas balance, however, prices will largely be impacted by oil prices. This is not to say that the ratio to crude oil prices can vary, and in fact it has weakened considerably since the pre-Katrina/Rita time period.

There appear to be limits to the discount, however, due both to fundamental fuel switching economics at the margin and the paper arbitrage opportunities.

As such, we must look at our June target (basis July NYMEX) in the context of our expected \$115.00 per barrel WTI average for the second quarter. April WTI averaged \$112.47 per barrel and the way May is going this month should average \$122.00 per barrel if not higher.

This would imply under our Base Case a June average of about \$110.00-\$111.00 per barrel. While clearly we could be conservative, if our oil balances are correct that U.S. crude stocks should build further, such retracement back to recent support is not beyond possibility.

As such, incorporating our end-June storage target along with the WTI assumption and a \$24.00 per barrel heat crack reflecting distillate strength yields a June natural target including our "oil premium" of about \$10.85 per mmBtu.

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

1990-2007 Relationships \$3.50(E)
1990-1999 Relationships \$1.90(E)

2000-2007 Relationships \$5.20(E)

2000-2007 Relationships Plus Oil Premium \$10.85(E)(a)

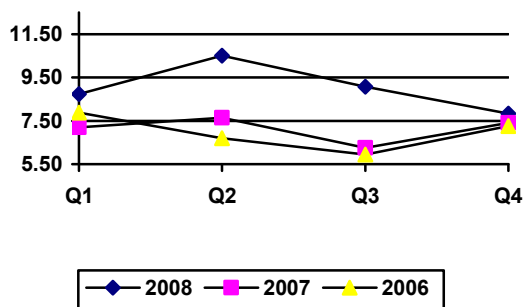
a) @ 320 cents per gallon distillate and \$110.50 per barrel WTI.

Although higher than last month, if reasonable it would not be inconsistent with our recommendation that producers complete 2008 hedges with the prompt month at \$11.10+ per mmBtu.

In the second half of the year, we are looking for more manifestations that higher oil prices are more severely impacting OECD oil demand and, as recently discussed, the approach of the November Presidential elections could increase concern among funds that some action will be taken to deter "speculation".

As such, along with an expected weakening in crude oil prices from the second quarter we would look for some sympathetic weakening in natural gas prices as well. Overall, we now expect a 2008 prompt NYMEX/Henry Hub average of about \$9.05 per mmBtu, marking an upward revision from last month by \$.65 per mmBtu.

Henry Hub Prices 2006-2008 (Dollars per MCF)



May 9, 2008

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	5,019	4,879	4,985	5,112	19,994	3.7
Withdrawals From Storage	1,791	241	325	964	3,321	33.2	1,964	368	401	650	3,383	1.9
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	1,021	974	1,097	1,099	4,191	-8.9
Canada	967	853	965	991	3,777	5.2	931	858	966	990	3,744	-0.9
LNG	184	280	227	79	771		82	105	120	100	407	
Other	18	16	12	9	54		8	11	11	9	39	
Balancing Item	37	111	12	(431)	(271)		53	36	0	0	89	
Total Supply	7,649	6,272	6,439	6,630	26,989	6.8	8,065	6,271	6,499	6,873	27,708	2.7
Disposition												
Additions To Storage	328	1,209	1,063	546	3,146	7.5	347	1,221	1,074	551	3,193	1.5
Exports	203	171	198	238	809	11.7	270	195	185	205	855	5.7
Consumption	7,118	4,892	5,178	5,846	23,034	6.5	7,448	4,855	5,240	6,117	23,660	2.7
Lease And Plant Fuel	281	289	297	303	1,170	4.2	302	293	299	307	1,201	2.6
Pipeline and Distribution Use	192	132	140	159	623	6.5	194	156	159	169	678	8.8
Residential	2,320	761	347	1,296	4,724	8.2	2,454	735	350	1,421	4,961	5.0
Commercial(a)	1,262	564	377	806	3,009	6.2	1,354	540	375	893	3,163	5.1
Industrial	1,777	1,554	1,569	1,735	6,635	2.2	1,841	1,510	1,562	1,752	6,666	0.5
Electric Power	1,286	1,592	2,448	1,547	6,873	10.5	1,303	1,621	2,494	1,575	6,992	1.7
Total Disposition	7,649	6,272	6,439	6,630	26,989	6.8	8,065	6,271	6,499	6,873	27,708	2.7
Addendum:												
Net Storage Injections	(1,463)	968	738	(418)	(175)		(1,616)	853	672	(98)	(189)	
End Period Working Gas In Storage	1,603	2,580	3,316	2,879	2,879		1,266	2,119	2,791	2,693	2,693	
Henry Hub Price (Dollars Per mmBtu)	7.20	7.64	6.25	7.41	7.12	2.6	8.74	10.51	9.08	7.83	9.04	26.9
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%						89%	
Total Recoverable Reserves (Bcf)					186,486	-0.3					184,314	-1.2
Reserve To Production Ratio(Years)					9.7						9.2	

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

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(a) Includes minor use as vehicle fuel.