



HORNSBY & COMPANY, INC.

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Energy Risk
Management Services

U.S. Natural Gas Perspectives Monthly Review and Outlook

Summary

Since our last report, the prompt NYMEX natural contract has risen by some \$.75 per mmBtu on a point-to-point basis. Surging crude oil prices to all-time record highs have pulled natural gas up in sympathy, aided as well by periodic discounting of tropical storm activity. From a fundamental basis specific to gas itself, however, weekly storage builds have not been consistently onerous, which we believe has come as a surprise to many analysts who are expecting pre-winter storage levels at the end of October to come in either close to or actually set another all-time record. Domestic dry gas production has been surging, and U.S. manufacturing activity is anything but robust, showing little sign of any short-term improvement. Our sense is that the U.S. economy could easily get worse before it gets better.

Having said this, however, our updated balances still point to a relatively constructive second half of 2008. As we have anticipated, LNG imports remain below the levels of last year thus far, helping to offset rising domestic production. In addition, exports of natural gas have been running modestly higher than anticipated. On the demand side, despite weak manufacturing activity in general recent DOE data, although subject to revision, suggest somewhat stronger demand by the industrial sector, complementing rising consumption by the electric utility sector. Putting it all together, our balances suggest a modestly higher net storage draw for 2008 than previously anticipated. Our balances do not assume any material disruption in supply as a result of upcoming hurricane activity, and we assume normal third and fourth quarter weather.

Therefore, in our mind if natural gas prices are destined to weaken significantly from current levels, it will be due more to a major drop in crude oil prices as opposed to a bearish natural gas balance. With regard to price expectations, we have revised up our forecast prompt NYMEX/Henry Hub average for this year by \$.40 per mmBtu to around \$10.00 per mmBtu.

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- + U.S. natural gas demand is expected to increase by 3.3%, or about 765 bcf in 2008.
 - + Domestic dry gas production is forecast to rise by 5.1%, or some 990 bcf this year.
 - + Our balances imply a net draw in working storage for 2008 of about 150 bcf.
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Viewpoint

Since the publication of our last monthly report, the prompt NYMEX natural gas contract has gained some \$.75 per mmBtu on a point-to-point basis, currently trading at about \$13.10 per mmBtu. Within the period, the prompt contract reached a settlement high of \$13.577 per mmBtu on July 3.

Crude oil prices have surged to new all-time record highs, most recently settling at \$145.29 per barrel also on July 3, anticipating a disruption in Arabian Gulf oil supplies in the event of a strike against Iranian nuclear facilities. Oil's gains have pulled natural gas up in sympathy, with natural aided as well by the periodic discounting of tropical storm activity.

Funds reporting to the CFTC have had little price impact, with rising net short positions over the period counter-intuitively corresponding to the rise in price. This most likely reflects activity to hedge long crude oil positions, and possibly as hedges against natural gas longs on the OTC market.

From the standpoint of fundamentals specific to the gas market itself, however, weekly storage builds have not been consistently onerous, leading in turn to a widening of the year-over-year storage "deficit".

We believe this phenomenon has come as a surprise to many analysts who are looking for end-October storage levels to lie either close to or actually set another all-time record high in advance of the 2008-2009 heating season.

Domestic dry gas production has been surging over the past number of months. U.S. manufacturing activity is relatively weak and shows little sign of improvement. We in fact believe that the U.S. economy may get worse before it gets better, as consumers continue to retrench in the face of a declining housing market and rising energy and food prices.

Having said this, however, our updated balances point to a relatively constructive second half of 2008, as they consistently have for the last several months.

As we have anticipated LNG imports remain below the levels of last year thus far, helping to offset rising domestic dry gas production. In addition, exports of natural gas to both Canada and Mexico have been running modestly higher than anticipated.

On the demand side, despite relatively weak manufacturing activity in general recent DOE data, although subject to revision, suggest somewhat stronger than expected demand by the industrial sector, complementing gains in gas consumption by the electric utility sector.

Putting all sides together, our balances suggest a somewhat higher net storage draw for 2008 than anticipated in last month's report. We would also note that our balances do not assume any material or sustainable disruption in GOM supply as a result of upcoming hurricane activity, and we assume, as always, normal third and fourth quarter weather.

Therefore, any significant weakening in natural gas prices from current levels will likely be due more to a major decline in crude oil prices as opposed to a response to a bearish natural gas balance.

In this context, we have revised up our forecast prompt NYMEX/Henry Hub average for 2008 by about \$.40 per mmBtu to \$10.00 per mmBtu. However, given where crude oil prices have been trading and the possibility of at least some precautionary weather-related GOM production facilities, our price outlook could easily end up on the conservative side.

Demand: Review and Outlook

Updated numbers from the Department of Energy reveal relatively little revision to preliminary estimates with the exception of the electric utility sector, where first quarter and April demand came in somewhat above expectations.

Residential and commercial sector first quarter demand was unrevised, and accounted for some 22% of the first quarter gain in U.S. gas demand, a somewhat lower share than first estimated due to relative strength in other sectors.

Industrial sector demand is holding up reasonably well, and as our customary table below illustrates, May output for the eight largest industrial consumers of natural gas turned in a mixed bag once again, but in the aggregate there was not a significant deterioration in the year-over-year comparison relative to April. The May index of total

manufacturing eased by 0.3% versus May of 2007, “less weak” than we had assumed.

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

Industry	YOY %Chg. Output
Chemicals	+0.6
Petroleum and Coal	-0.1
Primary Metals	+1.7
Paper	-2.6
Food	+0.3
Non-Metallic Mineral	-3.9
Fabricated Metal	+1.0
Transportation Equip.	-7.3

Looking down the road, for the second half of the year our Base Case assumes a modest improvement in manufacturing growth in the fourth quarter, with “water treading”, but no significant deterioration, for the third quarter. These assumptions lead to a 3.0%, or 200 bcf rise gain for industrial sector gas demand in 2008, a modest upward revision from last month’s report.

With regard to weather, we assume, as is our custom, normal cooling degrees days for the third quarter and normal heating degree days for the fourth, with the latter population weighted by home gas furnaces.

Electric utility gas demand is forecast to rise by 3.6%, or some 245 bcf this year, implying a moderation in growth from 2007’s +10.5% gain in demand largely reflecting the moderation in economic activity now under way.

Taking all sectors together, we believe U.S. natural gas consumption will increase by 3.3%, or 765 bcf this year, marking an upward revision from our previous assessment by some 110 bcf.

**Supply:
Review and Outlook**

As discussed in previous reports the progressive rise in gas prices has led to

successful domestic drilling in a number of plays, leading in turn to one of the largest increases in domestic output we have seen in quite a period of time.

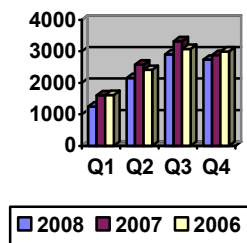
We expect a gain in U.S. dry gas production this year of 5.1%, or about 990 bcf, an upward revision from last month by about 45 bcf. We concede we expect a somewhat lower rate of growth by the fourth quarter, but believe it to be reasonable taking into account the net effect of mature onshore fields.

On the import side, LNG cargoes coming into the United States for the first four months of the year are off by about 175 bcf, or some 62% from the comparable period in 2007.

At the same time, while pipeline imports from Canada are up slightly over last year for the same time period, exports to Canada from the U.S. are up by a larger degree, as are exports to Mexico.

Domestic producers are therefore able to maximize wellhead prices, depending upon the region, as well as production, due to the reduction in net imports despite moderating economic activity.

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



Putting together demand and supply, our Base Case now implies a modestly greater net draw in working storage for 2008 than forecast in last month’s report. We estimate that end-June storage stood some 425 bcf below the end of June last year.

At the end of the third quarter, our balances suggest a year-over-year deficit of some 410 bcf. Prior to the onset of next winter, our out look implies an end-October working storage level a shade below 3.1 tcf.

If our outlook is reasonable, it suggests a more constructive balance for the remainder of the year than the consensus assumes. Barring a major economic decline combined with larger gains in domestic output and a resurgence in LNG imports, we still believe the odds do not favor beginning next heating season with another record volume of gas in storage.

Implications for Price

In our last World Petroleum Perspectives, we revised up modestly our outlook for WTI for the remainder of the year, with a \$110.00 per barrel average expected for September, which we now incorporate into our short-term pricing model.

Also taking into account our updated gas balances, our model implies a September (basis October NYMEX) target of about \$11.30 per mmBtu. Once again our balances assume no material or sustainable impact from any prospective hurricane activity.

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

1990-2007 Relationships \$3.55(E)
1990-1999 Relationships \$1.95(E)
2000-2007 Relationships \$5.60(E)

2000-2007 Relationships
Plus Oil Premium \$11.30(E)(a)

a) @ 315 cents per gallon distillate and \$110.00 per barrel WTI.

As we issue this report the October NYMEX contract is trading about \$1.80 per mmBtu above our target, and we fully concede that if we are off the mark, prices are likely to be trading higher and not lower as we end the summer.

Nonetheless, our outlook for oil still assumes that world oil demand growth will moderate further, and that we will witness a “post Olympics” sell off for both psychological

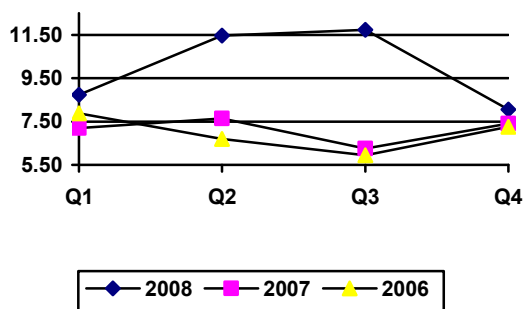
and fundamental reasons reflecting moderating demand growth in China.

Iran’s nuclear capability and what will be done about it remain problematic, and we also concede that until a strike occurs, crude oil may remain well supported above both fundamental and “fund” value.

Overall, however, we do not anticipate \$200.00 per barrel WTI or even \$150.00 per barrel WTI for any period of time, and the weight of higher oil prices is clearly having a negative impact on OECD and now, to a lesser extent, non-OECD economies.

For 2008 as a whole, we are looking for prompt NYMEX/Henry Hub to average \$10.00 per mmBtu, marking an upward revision from last month’s report by some \$.40 per mmBtu.

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



July 7, 2008

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

	Q1	Q2	Q3	Q4	2007	%Chg 07-06	Q1	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	5,080	5,046	5,029	5,112	20,267	5.1
Withdrawals From Storage	1,791	241	325	964	3,321	33.2	1,891	333	320	724	3,268	-1.6
Supplemental Gaseous Fuels	18	14	15	13	61	-9.6	11	14	15	13	54	-11.0
Imports	1,165	1,148	1,206	1,083	4,602	9.9	1,060	972	1,089	1,103	4,224	-8.2
Canada	963	852	967	995	3,777	5.2	982	871	968	994	3,814	1.0
LNG	184	280	227	79	771		76	92	110	100	378	
Other	18	16	12	9	54		3	9	11	9	32	
Balancing Item	41	110	11	(436)	(274)		(13)	54	50	(80)	11	
Total Supply	7,649	6,271	6,439	6,629	26,987	6.8	8,029	6,419	6,503	6,872	27,824	3.1
Disposition												
Additions To Storage	328	1,209	1,063	546	3,146	7.5	255	1,239	1,074	551	3,119	-0.8
Exports	203	171	198	238	809	11.7	317	202	185	205	909	12.4
Consumption	7,118	4,891	5,178	5,845	23,032	6.5	7,457	4,978	5,244	6,116	23,795	3.3
Lease And Plant Fuel	281	289	297	303	1,170	4.2	307	304	302	307	1,220	4.2
Pipeline and Distribution Use	192	132	140	159	623	6.5	199	156	161	169	685	9.9
Residential	2,320	761	347	1,296	4,724	8.2	2,355	735	350	1,421	4,862	2.9
Commercial(a)	1,262	563	377	805	3,007	6.1	1,303	504	375	892	3,075	2.3
Industrial	1,777	1,554	1,569	1,735	6,635	2.2	1,872	1,647	1,562	1,752	6,834	3.0
Electric Power	1,286	1,592	2,448	1,547	6,873	10.5	1,421	1,630	2,494	1,575	7,120	3.6
Total Disposition	7,649	6,271	6,439	6,629	26,987	6.8	8,029	6,419	6,503	6,872	27,824	3.1
Addendum:												
Net Storage Injections	(1,463)	968	738	(418)	(175)		(1,636)	907	754	(173)	(148)	
End Period Working Gas In Storage	1,603	2,580	3,316	2,879	2,879		1,247	2,154	2,907	2,735	2,735	
Henry Hub Price (Dollars Per mmBtu)	7.20	7.64	6.25	7.41	7.12	2.6	8.74	11.46	11.73	8.05	10.00	40.3
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%						88%	
Total Recoverable Reserves (Bcf)					186,486	-0.3					184,042	-1.3
Reserve To Production Ratio(Years)					9.7						9.1	

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

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(a) Includes minor use as vehicle fuel.