HORNSBY & COMPANY, INC.

www.hornsbyco.com

Energy Risk
Management Services

U.S. Natural Gas Perspectives
Monthly Review and Outlook

Summary

Since our last monthly report, the prompt NYMEX natural gas contract has fallen by about $.50 per mmBtu. The story remains the same: incessant weekly storage builds generally above consensus expectations and a lack of hurricane activity thus far have largely accounted for the decline. Large CFTC-reporting commodity funds have compounded natural's woes, building the largest net short position in history. While many if not most of these funds are selling natural gas based on its own fundamentals, we sense that some are also selling natural as a hedge against their long crude oil positions, a trade that up until recently has worked quite well. The guiltiest component of the storage builds has been rising LNG imports, with attractive netbacks drawing incremental cargoes. In addition, however, domestic dry gas production is improving a bit more than expected, while manufacturing output in general, and gas-intensive industries in particular, are progressively weakening from earlier in the year relative to the same period in 2006.

Taking all this into account, we have made some revisions to our outlook for the remainder of 2007. Whereas our Base Case had pointed to more than ample storage going into next winter, our updated forecast suggests that based on current trends the market could be entering next winter with one of the largest working storage positions in history. Much could happen between now and then, however, since out outlook assumes no major production impact from any Gulf of Mexico hurricane activity that may yet develop. Probability implies that some precautionary platform shutdowns are likely, which would help alleviate the pre-winter storage position. Nonetheless, if manufacturing activity continues to weaken even more, lower than expected industrial gas demand could offset any temporary reductions in production. Having said all this, however, our models still suggest, despite our need to revise downward our price outlook through the remainder of 2007, that October natural is somewhat undervalued, with our target for September now set at $7.00 per mmBtu. For 2007 as a whole we are now looking for Henry Hub/NYMEX to average about $7.15 per mmBtu, implying that early winter contracts remain overvalued. Our price forecast for 2008 remains at $7.50 per mmBtu.

+ U.S. natural gas consumption is forecast to rise by 1.2%, or some 275 bcf next year.

+ 2008 domestic dry gas production is expected to gain by 0.4%, or about 75 bcf.

+ Our balances imply a net working storage draw next year of 245 bcf.

Viewpoint

Since the publication of our last monthly natural gas report, the prompt NYMEX natural gas contract has fallen by about $.50 per mmBtu. As we issue this report, the contract is attempting to find some stability around $6.00 per mmBtu.

The reasons behind the decline are unchanged: unending weekly storage builds generally above consensus expectations combined with a lack of active hurricane activity thus far in the season.

Large CFTC-reporting commodity funds have clearly compounded the price drop, having progressively increased their net short positions to the largest such position on record.

To quantify, on July 3, the data point closest to the publication of our last report, funds held net shorts of 48,164 contracts when the prompt natural contract settled at $6.671 per mmBtu. On July 31, funds had increased net shorts to 71,001 contracts with the contract settling at $6.191 per mmBtu.

While we believe that most of these funds were selling natural gas in response to its own fundamentals, we also sense that some have been selling natural as a hedge against their long crude oil positions, where net longs had reached an all-time record, a trade that up until recently has generally worked.

Attempting to strike a fundamental balance when faced with only weekly storage data, we believe that a major factor has been a significant increase in LNG imports, with attractive netbacks drawing incremental cargoes in combination with contract volume buildup.

In addition, domestic dry gas production is rising somewhat more than expected, while according to the Federal Reserve Board manufacturing growth in general, and gas-intensive industries in particular, are progressively weakening from earlier in the year relative to the same period last year.

Taking all this into account, we have made some revisions to our outlook for the remainder of 2007, with the net effect a somewhat larger net storage build expected for this year than previously, when our balances were already implying more than ample gas supplies ahead of next winter.

Our updated forecast suggests that based on current trends the market could be entering next winter with one of the largest working storage positions in history.

Of course, much can happen between now and the end of October, since out outlook assumes no major production impact from any Gulf of Mexico hurricane activity that may yet develop.

The laws of probability imply that some precautionary platform shutdowns are likely over the course of the next three months, which would help alleviate the pre-winter storage position.

At the same time, if manufacturing activity continues to weaken even more than we anticipate, lower than forecast expected industrial gas demand could well offset any temporary reductions in production.

Having said all this, however, our pricing models still suggest, despite our need to revise downward our price outlook through the remainder of 2007, that October natural is somewhat undervalued, particularly relative to crude oil, with our target for September now set at $7.00 per mmBtu. To fully negate our models' price output would require WTI to fall below $60.00 per barrel, which our Base Case dos not assume during the second half of the year.

For 2007 as a whole we are now looking for Henry Hub/prompt NYMEX to average about $7.15 per mmBtu, implying that early winter contracts remain overvalued. Our price forecast for 2008 remains at $7.50 per mmBtu.

Demand:
Review and Outlook

For the first time in a while the Department of Energy did not make any material revisions to 2006 natural gas demand, so we are starting with roughly the same base as last month.

Looking first at the industrial sector, as our customary table below illustrates the output of the most gas-intensive industries weakened further in June relative to the prior year, with June total manufacturing up a relatively anemic 1.6% versus June of 2006.

For the last couple months, therefore, aggregate manufacturing activity has improved at a slower rate than our long-standing conservative Base Case assumption for 2007 of +2.5%.

Eight Largest Industrial Consumers of Natural Gas

June Manufacturing Output

Industry	YOY %Chg. Output
Chemicals	**-1.0**
Petroleum and Coal	**-1.5**
Primary Metals	**-3.3**
Paper	**-1.7**
Food	**+4.5**
Non-Metallic Mineral	**-3.4**
Fabricated Metal	**+2.0**
Transportation Equip.	**+2.3**

While we believe the current situation with regard to the housing sector and subprime mortgage woes should be monitored carefully, at this point we have not made any revision to our economic assumptions for the remainder of the year. As such, for 2007 we estimate that industrial sector gas demand will decline by 2.0%, or some 130 bcf.

In the electric utility sector, demand continues to improve reflecting rising electricity output and new gas-fired capacity coming online. For this year we are looking at a gain of 6.2%, or about 385 bcf.

With regard to the residential sector, we estimate demand to be up by 9.8%, or around 425 bcf in 2007, with of course virtually all of the gain having come in the first five months of the year.

Adding in the commercial and other minor sectors, we anticipate U.S. natural gas consumption will rise by 4.1%, or about 890 bcf this year, a slight downward revision from last month's assessment.

For 2008, our models suggest a more moderate demand increase of 1.2%, or some 275 bcf, about unchanged from last month. Our outlook once again assumes normal heating and cooling degree days for the year, and continued moderate economic growth, but no recession.

Supply: Review and Outlook

In the first section of this report we highlighted the rise in LNG imports as playing a major role in the average larger-than-expected storage builds experienced to date. As an example, in the month of May, the latest month of DOE data, LNG gross imports totaled about 94.3 bcf, up from January's level of some 53.4 bcf.

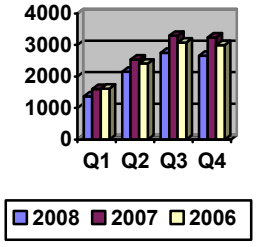
Accounting for the increase was a 20+ bcf increase from Algeria, and a 10-odd bcf gain from Nigeria. We have revised up modestly our LNG import assumptions for the remainder of the year, which we have consistently believed would more than offset any declines in Canadian pipeline imports.

Domestic dry gas production is holding up well, based on preliminary data through May, and we estimate that in 2007 output will rise by 1.5%, or about 280 bcf. For 2008 we are looking for a more modest gain in production of 0.4%, or some 75 bcf.

Putting our demand and supply side together, for 2007 we anticipate a net build in working storage of around 175 bcf, greater than last month's estimate by some 185 bcf. At the end of the third quarter, we now believe working storage will total almost 3.3 bcf, with obviously more than ample supplies when the heating season officially begins at the end of October.

Once again our balances do not assume any material and/or sustainable disruption in output due to Gulf of Mexico hurricane activity, although as previously discussed there is a likelihood of some precautionary platform shutdowns between now and October, marginally alleviating the pre-winter storage position.

End-Quarter Working Gas Storage Levels (BCF)



In terms of next year, under the assumption of normal weather, a lack of recession, and a moderation in domestic production growth, our balances point to a 245 bcf net draw in working storage, less than forecast last month by about 130 bcf. End-2008 working storage is targeted at a bit under 3.0 tcf, which

would place us somewhat below the position at the end of 2006.

Implications for Price

As the prompt crude oil contract continues to weaken off last week's record highs, prompt natural is attempting to stabilize at around $6.00 per mmBtu.

Inputting our latest balances into our quarterly pricing models, we have been compelled to revise down our target for September, basis October NYMEX. As our table below illustrates incorporating our "oil premium" and assuming $66.00 per barrel WTI we are now looking at $7.00 per mmBtu as reasonable.

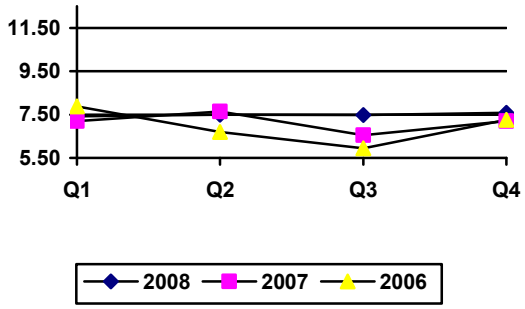
Henry Hub Price Outlook
Average for Month of September 2007
($/mmBtu)

1990-2006 Relationships	**$2.95(E)**
1990-1999 Relationships	**$1.75(E)**
2000-2006 Relationships	**$4.75(E)**
2000-2006 Relationships Plus Oil Premium	**$7.00(E)(a)**

a) @ 200 cents per gallon distillate and $66.00 per barrel WTI.

As we issue this report the October NYMEX contract is trading some $.75 per mmBtu below our target, selling at only 51% of crude oil. Thus, right or wrong, given the massive net short positions in natural gas, we believe there is scope for some reduction in this discount under the assumption that October WTI falls to $66.00 per barrel.

Henry Hub Prices
2006-2008
(Dollars per MCF)



For 2007 as a whole we now estimate that prompt NYMEX/Henry Hub will average $7.15 per mmBtu, marking a downward revision from last month's report by $.20 per mmBtu. Our outlook still suggests that November and December natural remain somewhat overvalued at this time.

For 2008, we retain our forecast that prompt NYMEX/Henry Hub will average $7.50 per mmBtu, implying a 75% discount to our estimated WTI average for next year of $60.00 per barrel. Our outlook therefore also assumes that first quarter natural remains somewhat overvalued at this time.

August 6, 2007

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

	Q1	Q2(E)	Q3(E)	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	4,602	4,689	4,755	4,766	18,812	**1.5**	4,620	4,707	4,774	4,785	18,887	**0.4**
Withdrawals From Storage	1,791	213	254	563	2,821	13.2	1,954	365	360	594	3,273	16.0
Supplemental Gaseous Fuels	18	12	16	16	63	1.5	19	12	16	16	64	1.5
Imports	1,147	1,089	1,159	1,146	4,541	8.4	1,174	1,021	1,132	1,138	4,464	-1.7
Canada	963	811	899	896	3,568	-0.6	939	791	877	873	3,479	-2.5
LNG	184	278	260	250	972		235	230	255	265	985	
Other	0	0	0	0	0		0	0	0	0	0	
Balancing Item	77	236	0	(75)	238		0	95	0	(40)	55	
Total Supply	7,636	6,238	6,185	6,416	26,475	4.0	7,767	6,200	6,282	6,495	26,743	1.0
Disposition												
Additions To Storage	327	1,149	1,011	510	2,997	2.5	330	1,160	1,021	515	3,027	1.0
Exports	203	207	175	205	790	9.0	180	185	185	205	755	-4.4
Consumption	7,106	4,882	4,999	5,701	22,688	**4.1**	7,257	4,855	5,076	5,774	22,961	**1.2**
Lease And Plant Fuel	282	285	285	286	1,138	0.2	277	282	286	287	1,133	-0.5
Pipeline and Dsitribution Use	186	134	143	145	608	5.6	152	151	153	158	614	0.9
Residential	2,316	763	341	1,361	4,782	9.8	2,436	715	344	1,375	4,871	1.9
Commercial(a)	1,260	562	388	829	3,039	6.1	1,324	524	386	825	3,060	0.7
Industrial	1,755	1,522	1,512	1,702	6,491	-2.0	1,735	1,537	1,533	1,727	6,531	0.6
Electric Power	1,307	1,616	2,330	1,378	6,631	6.2	1,332	1,645	2,373	1,403	6,753	1.8
Total Disposition	7,636	6,238	6,185	6,416	26,475	4.0	7,767	6,200	6,282	6,495	26,743	1.0
Addendum:												
Net Storage Injections	(1,464)	936	757	(53)	175		(1,624)	796	661	(79)	(246)	
End Period Working Gas In Storage	1,603	2,536	3,293	3,239	**3,239**		1,616	2,411	3,072	2,993	**2,993**	
Henry Hub Price (Dollars Per mmBtu)	**7.20**	**7.64**	**6.55**	**7.20**	**7.15**	**2.9**	**7.42**	**7.50**	**7.48**	**7.58**	**7.50**	**4.9**
Gas Wells Drilled					34,746	10.0					38,220	10.0
Total Discoveries(Bcf)					15,636	-1.0					15,288	-2.2
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)					19,636	-0.8					19,288	-1.8
Reserve Replacement Ratio					104%						102%	
Total Recoverable Reserves (Bcf)					187,700	0.4					188,101	0.2
Reserve To Production Ratio(Years)					10.0						10.0	

Source: Historical Data, U.S. Department of Energy.
Note: May not sum to totals in all cases due to rounding.
(a) Includes minor use as vehicle fuel.