



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 report the prompt NYMEX natural gas contract has declined by some \$.60 per mmBtu. A lack thus far of any material storm-induced disruption in Gulf of Mexico production combined with a rising storage overhang versus last year have contributed to the price decline. In addition, managed commodity funds continue to short the market, in part we believe as hedges against long crude oil positions. Moderating economic growth and discounting the possibility of a spread of the subprime mortgage crisis are also contributing to the weakness in the prompt month contract.

Despite the declines, our balances still suggest, as they have for some time, that the winter price curve will continue to “flatten” as we progress through time. As such, weaker than expected near term prices have not led to a material downward revision in price expectations for the remainder of the year. This month’s report “rolls” our quarterly price forecasting model to December, i.e. basis January NYMEX. Our model suggests, in line with our curve “flattening” scenario, that fair fundamental value for the January contract is \$7.15 per mmBtu, implying further weakness from current price levels.

With regard to our fundamental balances, we have made little revision relative to last month, and in fact now estimate that year-end working storage will come in a bit lower than previously expected. This is not due to an assumption of stronger economic growth, but rather “recalibrating” the DOE balancing item more consistently with historic experience. Nonetheless, our balances still suggest that working storage prior to the onset of next winter will be more than ample by any measure. Assuming a normal winter and the lack of a recession, our numbers for 2008 are unchanged from last month and imply a modest improvement in the balance with a net working storage draw forecast for next year as a whole. In terms of price, for 2008 we maintain our Base Case prompt NYMEX/Henry Hub average of \$7.50 per mmBtu in the context of WTI averaging some \$60.00 per barrel.

+ U.S. natural gas demand is forecast to rise by 1.2%, or some 275 bcf in 2008.

+ Domestic dry gas production is expected to gain by only 0.4%, or about 75 bcf next year, partly reflecting curtailed capital spending relative to previous budgets in response to weaker prompt prices.

+ Our balances imply a net draw in working storage in 2008 of some 280 bcf.

Viewpoint

Since the publication of our last monthly natural gas report the prompt NYMEX contract has declined by some \$.60 per mmBtu. As we issue this report October is trading around \$5.50 per mmBtu, unable to respond to a more modest than expected storage build for the week ending August 31.

Although Hurricane Dean led to modest production curtailments as a precautionary measure, a lack thus far of any material storm-induced disruption in Gulf of Mexico output has disappointed the bulls.

A rising storage overhang in this context versus last year has contributed to the price decline, with working storage now standing marginally above the comparable point in 2006, more than eliminating the deficit to last year that prevailed at the end of the second quarter.

In addition, managed commodity funds continue to retain sizable net short positions. Over the past month, CFTC data reveal that such funds have retained net shorts in a range of roughly 58,000-65,000 contracts, although reduced from the all-time record net short position held on July 24 of 71,675 contracts.

Although no doubt many funds feel justified in shorting natural gas on its own merits, right or wrong, we have to believe that another group of funds has been shorting natural as a hedge against long crude oil positions.

The natural gas balance is more "closed" compared to oil, although LNG imports have risen significantly this year, and thus is not directly subject to potential global disruptions in oil supply that funds hope will generate excess returns.

In addition, the natural gas market is more directly sensitive to moderating economic growth, with traders and funds also discounting the possibility of a spread of the subprime mortgage crisis to the broader economy.

Despite the prompt month price decline, our balances still suggest, as they have for some time as integral to our Base Case, that the winter price curve will continue to "flatten" as we progress through time.

As such, weaker than expected prompt contract prices have not led to a material downward revision in price expectations for the remainder of the year, since we had already

assumed that even if the prompt contract were trading above current levels, the outer month contracts would eventually be trading lower.

Our report this month "rolls" our quarterly price forecasting model to December, reflecting the January NYMEX contract. Our model suggests, in line with our curve "flattening" scenario, that fair fundamental value for the January contract is about \$7.15 per mmBtu, implying a decline of about \$.50 per mmBtu from current price levels.

With regard to our fundamental balances, we have made little revision relative to last month, and our numbers now in fact suggest that year-end working storage will come in a bit lower than previously anticipated.

We emphasize that this revision is not due to an assumption of stronger economic growth, but rather simply "recalibrating" the DOE balancing line item more consistently with historic experience. Nonetheless, our balances still suggest that working storage prior to the onset of next winter will be more than ample by any historical measure.

Assuming a normal winter, right or wrong, and the lack of a recession, our balances for 2008 are essentially unchanged from last month and imply a modest improvement in the natural gas picture, anticipating a net working storage draw for next year as a whole.

In terms of price, for 2008 we maintain our Base Case prompt NYMEX/Henry Hub average of \$7.50 per mmBtu in the context of WTI averaging some \$60.00 per barrel.

Demand: Review and Outlook

Once again the DOE was merciful with regard to data revisions, and updated numbers through June suggest that second quarter U.S. natural gas consumption came in a bit stronger than expected, with somewhat more robust June estimates for both the industrial and electric utility sectors.

Overall, at this point it appears that second quarter U.S. gas demand rose by a full 2.6%, or some 125 bcf versus the second quarter of 2006. Thus, it is not the demand side of the equation thus far that has hurt the balance, but

rather the supply side, which we address in the next section of this report.

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

Industry	YOY %Chg. Output
Chemicals	-0.7
Petroleum and Coal	-0.7
Primary Metals	-3.1
Paper	-1.0
Food	+4.8
Non-Metallic Mineral	-2.3
Fabricated Metal	+1.9
Transportation Equip.	+5.9

Our customary table above illustrates manufacturing output in July versus the previous year for the eight largest industrial consumers of natural gas. Relative to June, the data reveal, on average, a marginal improvement, thus helping to explain the recent improvement in the ratio of industrial gas demand to aggregate manufacturing output.

History is one thing, however, and the market is rightly focusing on prospects down the road. In this regard, as we have previously discussed we do not believe the subprime mortgage crisis will pervade the broad economy to the extent of compelling us to reduce either natural gas or refined product demand below our current expectations.

The most recent Beige Book data would confirm our perspective, although obviously August would have been too early in any event to witness a multiplier economic impact of subprime woes.

As our working assumption for next year, however, we have assumed no recession with modest gains forecast for manufacturing activity in the range of +2.5%, implying a “steady state” type of scenario relative to the current picture.

Incorporating this outlook with our assumption of normal heating and cooling degree days for calendar 2008, we expect U.S. natural gas demand to rise by 1.2%, or about 185 bcf next

year, implying a moderation in growth relative to our estimate for 2007.

**Supply:
Review and Outlook**

As discussed previously, the supply side has been the bane of the gas market this year, with domestic production increments from a number of areas, including the Rocky Mountains and the Barnett Shale play.

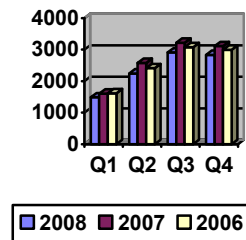
In addition, however, LNG imports continue to rise significantly versus last year, a trend that is unlikely to moderate to a material degree over the near term. Canadian pipeline imports have also held up somewhat better than anticipated.

The weakening price environment, however, has increased the odds that next year’s drilling budgets for at least some gas producers will end up lower than originally planned.

As such, with regard to domestic dry gas production, we are looking for a moderation in growth next year in contrast to our estimated gain in production for 2007 of 1.5%. For 2008, we expect output to rise by 0.4%, or around 75 bcf, a bit below our previous assessment.

We expect LNG imports next year to rise, but at a more moderate rate compared to this year, with Canadian pipeline imports forecast to decline at a somewhat higher pace than we expect for 2007.

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



Putting together the demand and supply sides of the equation, in terms of the remainder of 2007 we still expect pre-winter working storage levels to be more than ample by any historical measure. We have fine tuned our fourth quarter

view, however, after reviewing what appears to be a fairly consistent DOE balancing line item, or essentially a “fudge factor”. As such, we now look for year-end working storage to come in at about 3.1 tcf, below last month’s target by some 125-130 bcf.

For 2008, our Base Case still implies a modest improvement in the natural gas balance, aided by the assumption of normal first quarter weather and continued, albeit modest, growth in manufacturing output. The demand side is complemented by more modest growth on the supply side, overall leading to a net draw in working storage for 2008 of about 280 bcf, a larger net decline than forecast last month by about 35 bcf.

Implications for Price

Despite the recent surge in crude oil prices, the prompt NYMEX natural contract remains well below \$6.00 per mmBtu, and additional declines cannot be ruled out.

After coming close to the mark with our June price target, we obviously fell well short of the mark with regard to September, barring a major hurricane suddenly developing leading to a prolonged shut in of Gulf of Mexico production.

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

1990-2006 Relationships	\$3.45(E)
1990-1999 Relationships	\$1.90(E)
2000-2006 Relationships	\$5.69(E)

2000-2006 Relationships
Plus Oil Premium **\$7.15(E)(a)**

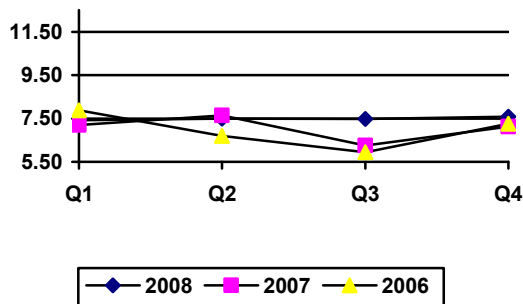
a) @ 200 cents per gallon distillate and \$66.00 per barrel WTI.

In this month’s report, we “roll” the short term to December, with our customary table above now providing a December target (basis January NYMEX). Although clearly the prompt NYMEX contract has fallen below our estimates for the current time period, consistently integral to our Base Case has been the belief that winter

NYMEX contracts were overvalued, incorporating both hurricane and cold weather premiums that we forecast would dissipate over time, thus “flattening” the curve.

As we issue this report our scenario is finally evolving, although we have yet to see what the remainder of hurricane season may have in store. Based on our latest fundamental balances for the remainder of the year, however, our pricing models suggest that after incorporating our “oil premium”, with January WTI targeted at \$66.00 per barrel, our December target is pegged at \$7.15 per mmBtu.

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



January NYMEX natural is currently trading at around \$7.65-\$7.70 per mmBtu, and thus our Base Case implies some further downside risk to outer month natural gas prices.

For next year, given little change to our balances and our forecast that WTI will average around \$60.00 per barrel, we retain our forecast prompt NYMEX/Henry Hub average of \$7.50 per mmBtu.

September 7, 2007

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

	Q1	Q2	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	4,678	4,755	4,766	18,801	1.5	4,620	4,697	4,774	4,785	18,876	0.4
Withdrawals From Storage	1,791	241	377	613	3,022	21.3	1,954	462	358	594	3,368	11.4
Supplemental Gaseous Fuels	18	12	16	16	63	1.5	19	12	16	16	64	1.5
Imports	1,147	1,091	1,159	1,146	4,543	8.5	1,174	1,026	1,132	1,138	4,470	-1.6
Canada	963	816	899	896	3,574	-0.5	939	796	877	873	3,485	-2.5
LNG	184	274	260	250	969		235	230	255	265	985	
Other	0	0	0	0	0		0	0	0	0	0	
Balancing Item	77	299	(125)	(125)	127		0	95	0	(40)	55	
Total Supply	7,636	6,321	6,182	6,416	26,556	4.4	7,767	6,292	6,279	6,495	26,833	1.0
Disposition												
Additions To Storage	327	1,209	1,011	510	3,057	4.5	330	1,221	1,021	515	3,088	1.0
Exports	203	201	175	205	784	8.2	180	185	185	205	755	-3.7
Consumption	7,106	4,911	4,996	5,701	22,715	4.2	7,257	4,886	5,073	5,774	22,990	1.2
Lease And Plant Fuel	282	287	285	286	1,140	0.4	277	282	286	287	1,133	-0.7
Pipeline and Distribution Use	186	129	143	145	603	4.7	152	150	153	158	613	1.7
Residential	2,316	762	341	1,361	4,780	9.7	2,436	714	344	1,375	4,870	1.9
Commercial(a)	1,260	562	388	829	3,039	6.1	1,324	525	386	825	3,060	0.7
Industrial	1,755	1,534	1,510	1,702	6,500	-1.8	1,735	1,549	1,530	1,727	6,541	0.6
Electric Power	1,307	1,637	2,330	1,378	6,652	6.5	1,332	1,666	2,373	1,403	6,774	1.8
Total Disposition	7,636	6,321	6,182	6,416	26,556	4.4	7,767	6,292	6,279	6,495	26,833	1.0
Addendum:												
Net Storage Injections	(1,464)	968	634	(103)	35		(1,624)	759	664	(79)	(281)	
End Period Working Gas In Storage	1,603	2,580	3,214	3,111	3,111		1,487	2,246	2,909	2,830	2,830	
Henry Hub Price (Dollars Per mmBtu)	7.20	7.64	6.26	7.12	7.05	1.6	7.42	7.50	7.48	7.58	7.50	6.3
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)					187,711	0.4					188,123	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.

(E) 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.

(a) Includes minor use as vent gas by ConocoPhillips Company, Inc. and W.H. Brown may, from time to time, have positions in the futures market relative to these recommendations.