

A Mid-Summer Travelers Guide For Navigating the Natural Gas Markets*

(*Those travelers with heart problems or sensitive to motion sickness are advised to wait until next year when the markets are anticipated to be less frightful).

The market does not need another report discussing why investors should be as nervous as we are about natural gas. News flash! They already are nervous (see our Feb 2006 tome “Natural Gas: Troubled Water vs. Smooth Sailing”). With gas at \$6/mcf, a bearish report on gas would be the equivalent of a WWF pile driver off the top rope. Entertaining but not particularly useful.

In this report, rather than donning on wrestling gear, we discuss the various factors impacting storage and natural gas markets this summer.



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Summary

Assuming normal summer weather, we are projecting a theoretical level of 3,800bcf of gas in storage at the end of the injection season (little changed from our Feb 06 estimate). Usable storage capacity of 3,500bcf creates a **physical storage overhang of ~300bcf this summer**. In other words, storage will fill to the brim and still leave 300bcf of gas homeless.

Hot weather is not sufficient to remove the overhang. A 15% warmer than normal summer (similar to 2005's near record heat) would only increase demand ~200bcf...leaving a physical storage overhang of 100bcf.

Recent positive storage data. The last four storage data points have implied improvement in demand. The likely source of the incremental demand is the power sector. Hot weather and cheap residual fuel (relative to natural gas) have gas-fired peakers running before oil driven units. See previous bullet point.

Hurricanes are unlikely to cure the gas market. 2004's Hurricane Ivan impacted GOM production 150bcf with little impact on demand. Perhaps with a hot summer, an Ivan-like storm could erase the remaining 100bcf overhang...but unlikely.

The production impact of Katrina and Rita was ~750bcf in 2005...more than sufficient to clear the 300bcf of projected physical storage overhang. However, a storm(s) large enough to have a 300bcf+ production impact likely make landfall on the TX/LA coast...creating an offsetting demand response similar to what we experienced over the past 9 months.

If weather is unlikely to fix the gas market overhang, **it will take lower prices to stimulate demand** (say \$5/mcf to compete with coal)...or **physical gas shut-ins** later in the summer (remember the gas bubble era?)

Historically, as storage exceeds 2,800bcf (we project mid July this year), aggregate storage injectivity begins to diminish. Above 3,000bcf it diminishes rapidly. Thus, **at storage levels $\geq 2,800$ bcf we are going to be more vigilant for signs of physical gas surplus** (weak spot gas prices, storage/pipeline anecdotes, etc.).

If usable storage capacity is higher than our 3,400 to 3,500bcf estimate, then the summer may not be as rough on the gas market as we currently anticipate...but it makes a cold winter (06/07) critical to maintaining the current \$9/mcf calendar 2007 NYMEX strip.

July 6, 2006 selected data	
E&P index - S&P1500	\$422
Oil service index - OSX	\$209
Majors index - XOJ	\$1,172
Crude oil, NYMEX front month (August)	\$75.14
Crude oil, NYMEX 12-month strip	\$76.96
Natural gas, NYMEX front month (August)	\$5.66
Natural gas, NYMEX 12-month strip	\$8.05

Current Situation

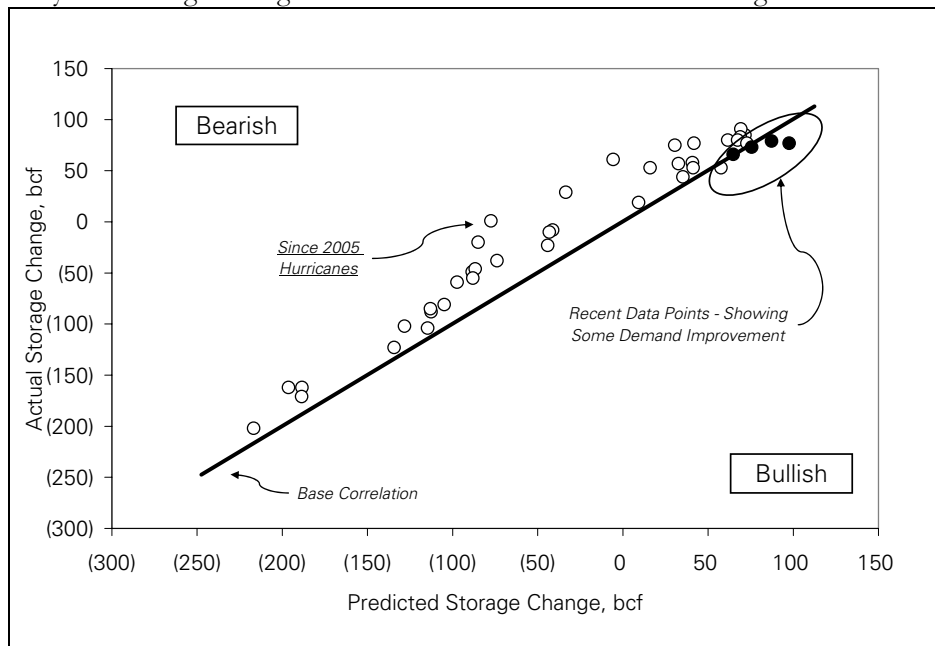
Current storage levels of 2,615 are 34% above normal and 13% above prior seasonal maximum levels. Weather adjusted, underlying supply and demand fundamentals continue to be soft. As a result, NYMEX front-month natural gas prices have fallen from \$11/mcf at the beginning of the year to ~\$5.50/mcf.

U.S. Working Gas Storage Trajectory – Record Levels

Total Inventory Levels	30-Jun-06	Year Ago	Normal	Max	Min	% Change		
						vs. Y-Ago	vs. Normal	vs max
Total	2,615	2,189	1,948	2,304	1,531	19%	34%	13%
East	1,409	1,137	1,051	1,246	892	24%	34%	13%
West	362	340	277	340	254	7%	31%	7%
Producing	844	712	598	777	340	19%	41%	9%

To help assess the underlying balance of supply and demand fundamentals, we compare our predicted storage change to actual results. The base correlation in the following graph is the trendline established during 2002 thru 2004. This analysis is backward looking, but it has consistently shown that weather adjusted storage results are bearish compared to the 2002-04 established trendline.

Weekly Gas Storage Change – Recent Data More Bearish Than Long-Term Trend Line



Sources: DOE, NOAA, and Pickering Energy Partners

Bearish data since hurricanes... The discrete data points since the 2005 hurricanes, adjusted for GOM production disruptions, are shown on the graph (the solid points represent the most recent four weeks). Data points above the trendline suggest bearish fundamentals...actual injections higher than predicted and actual withdrawals lower than predicted. We believe the continued underperformance is driven by ongoing demand dislocation (caused by higher prices), onshore production growth and efficiency measures by industrial, residential and commercial consumers.

*Positive recent data points...*Data for the most recent four weekly storage reports falls on/below the equilibrium trend line, signaling some underlying demand improvement. These are the first four weeks with significant summer electricity demand (hot weather) and suggest that gas-fired power generation is taking the place of residual fuel powered generation. We are watching this closely over the coming weeks to see if there is more weather-related natural gas demand than we anticipated.

Summer Storage...When Does Storage Fill?

We are projecting ~3,800 bcf of working gas in storage by the end of the injection season which does not “square” with our estimate of 3,400 to 3,500bcf of usable working gas capacity (see our March 06 report titled “Everything You Wanted to Know About Natural Gas Storage but Were Afraid to Ask”). We simply have too much gas...**~300bcf too much assuming normal weather.**

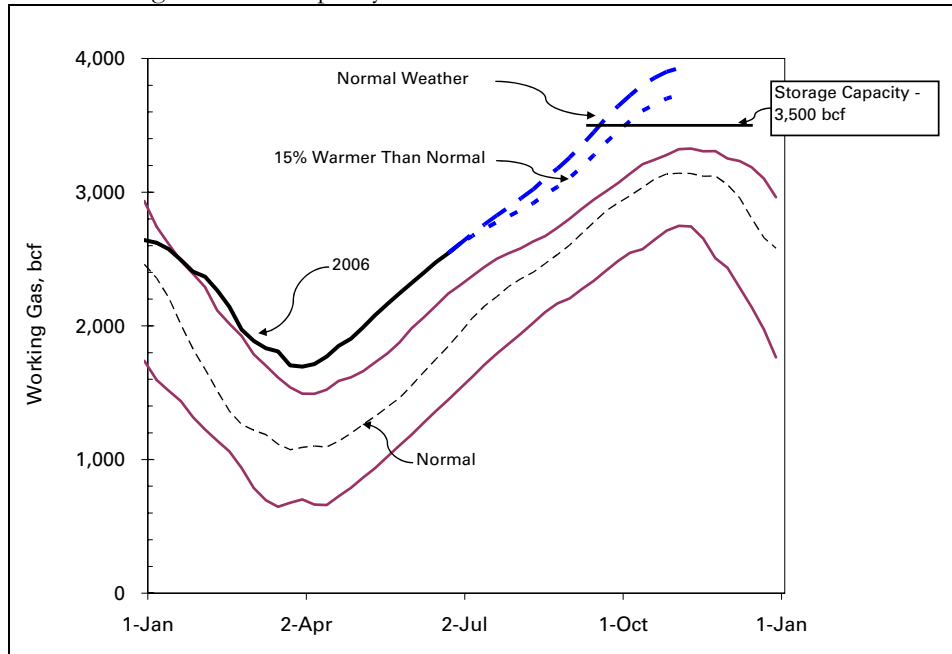
Hot Weather? Warm weather is not enough to work through the storage overhang. A summer that is 15% warmer than normal (looking at past eight years) will only increase gas-fired power demand by ~200bcf...leaving the market 100bcf oversupplied. This is equivalent to the summer of 2005, which was one of the hottest summers on record.

With natural gas priced below residual fuel oil, there may be more summer demand for natural gas than typical as gas-fired peaking plants will be dispatched into the grid before oil-fired peaking units. This could add another 100bcf of demand this summer. Residual fuel oil is currently priced at ~\$8/mcfe.

Hurricanes? – A repeat of 2005’s Hurricanes Katrina and Rita could impact supply (nearly 800bcf) but hurricanes large enough to impact that much production infrastructure will likely impact demand as well. We believe KatRita impacts were a net negative for gas markets given the current supply and demand balance. A better analog might be to look at 2004’s Hurricane Ivan...which impacted supply by 140bcf without a significant onshore demand impact. Hoping for two or more Ivan-like storms is betting against realistic probabilities.

Bottom Line on Weather– Summer weather is extremely unlikely to resolve the storage overhang. It would take an unlikely combination of a blazing hot summer and an Ivan type hurricane (supply impact with no demand impact). This could remove ~350 to 400bcf of the gas overhang...preventing a massive overfill this summer.

Summer 2006 U.S. Gas Storage Projections
Storage Exceeds Capacity Even With Warmer Than Normal Weather



Sources: DOE and Pickering Energy Partners

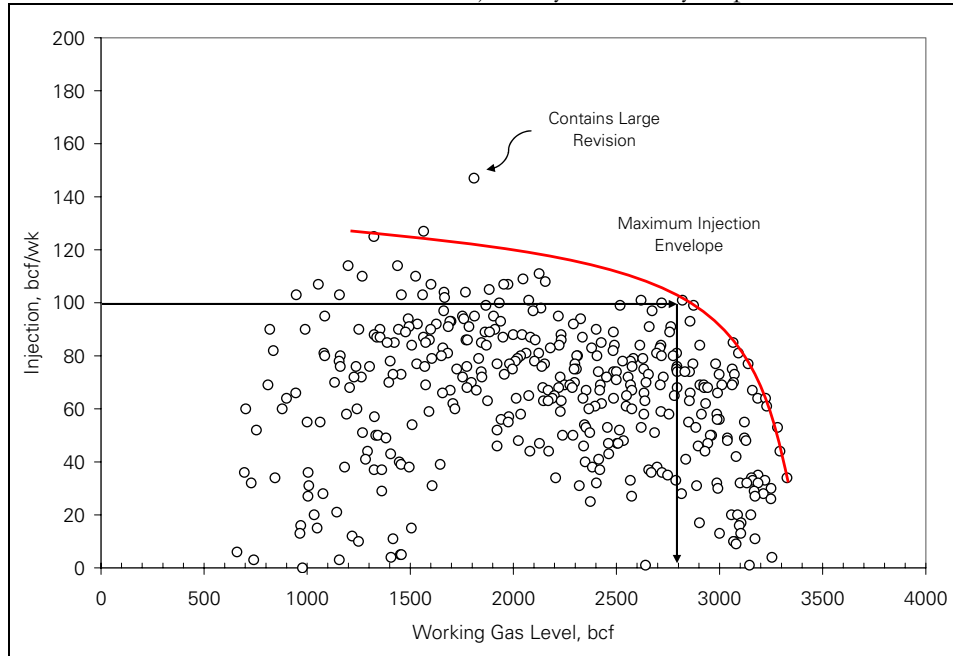
Low Prices? Clearing the storage overhang via demand will take lower prices. As we highlighted in our Feb 06 Natural Gas report, efficient natural gas fired generation can compete with less efficient coal fired generation in certain regions at \$5/mcf gas. With ~120 days remaining in the injection season and a 300bcf overhang to address, incremental demand would need to be ~2.5bcf/day.

Shut-ins? If a combination of low prices and weather are not sufficient to erase the storage overhang, gas producers will be forced to shut-in production. This was a common occurrence from 1985 to 1994 (the “gas bubble” era). As storage sites fill, pipeline pressure increases and the pipelines force E&P companies to reduce production. *When this occurs, cash gas prices approach lifting costs in basins where shut-ins are significant.*

When do shut-ins occur? Given a normal summer, we project storage to reach 3,400bcf in early September. If the summer is 15% warmer than normal, 3,400bcf is reached in late September. Shut-ins can occur well before max storage capacity is reached. It is like blowing up a balloon; the last few breaths are more difficult. The following graph illustrates the difficulty of filling the “storage balloon” once working gas exceeds 2,800bcf. The peak historical weekly injection with working gas levels ~2,800bcf is 100bcf...at 3,000bcf it is 90bcf/wk...at 3,200bcf it is 60bcf/wk.

We expect storage to reach 2,800bcf in mid July. This does not mean injection problems are a given, but we will certainly watch more closely.

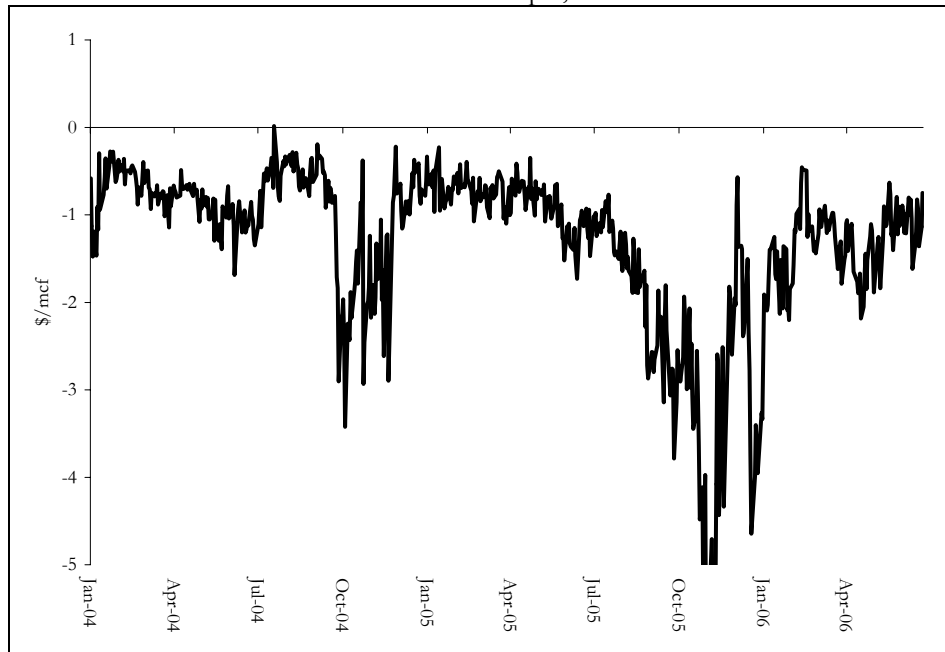
Maximum Storage Injections As a Function of Working Gas Volume-
2,800 bcf is Point Where Injectivity Potentially Impacted



Sources: DOE and Pickering Energy Partners

Natural Gas Differentials – As storage reaches “full”, regional spot prices will be impacted as pipelines force producers to shut-in production. We are monitoring various regional price differentials to see if gas prices signal production shut-ins.

Natural Gas Price Differentials
NYMEX less Opal, WY



Sources: Bloomberg and Pickering Energy Partners

Natural Gas Differential to NYMEX
Average Summer for Selected Hubs

	Current Differential to NYMEX	July 2004 Average	July 2005 Average
OPAL (Rockies)	-\$0.97	-\$0.68	-\$1.13
WAHA (Barnett)	-\$1.11	-\$0.38	-\$0.46
AECO (Canada)	-\$0.68	-\$0.89	-\$1.32
Carthage (E. TX)	-\$0.60	-\$0.28	-\$0.19

Sources: Bloomberg and Pickering Energy Partners

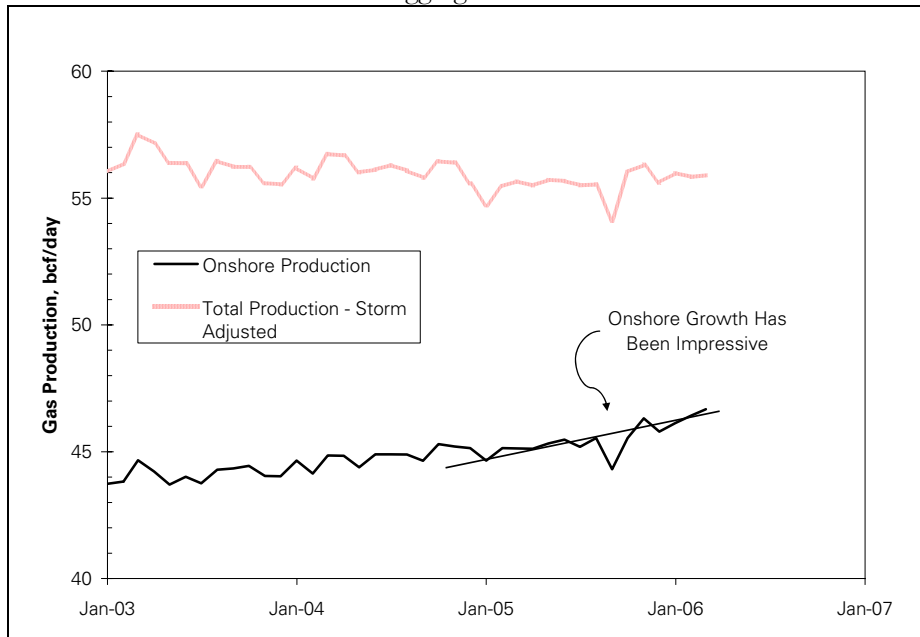
Lagniappe – Actual storage capacity is a very important number. Although we believe operational storage capacity is between 3,400 and 3,500 bcf (see previously referenced March 06 Storage Report, the possibility exists that storage could exceed these levels. The economic incentive (contango between summer and winter futures prices) is at record levels...by a wide margin (>\$4/mcf). This extreme economic incentive could cause storage to fill higher than we currently think possible (increased storage capacity can occur via new field adds and/or improving existing facilities).

If there is higher actual storage capacity, it would mean a less *bearish gas market this summer* (less physical storage “overhang”) but *less certainty for the 2007 outlook*. Record storage levels to start winter creates the need for a cold winter to remove the physical storage overhang...making a bullish natural gas thesis predicated (at least partially) on a weather bet.

Other Factors Affecting Our 2007 Natural Gas Outlook

Production Growth – Onshore natural gas production is growing...+3.5% so far this year in response to increased onshore rig count. Onshore growth has been offset by declining GOM production (natural decline and storm impacts). After adjusting GOM production for storms, total US production is essentially flat. We expect slight growth (storm adjusted) in 2H06 and 2007.

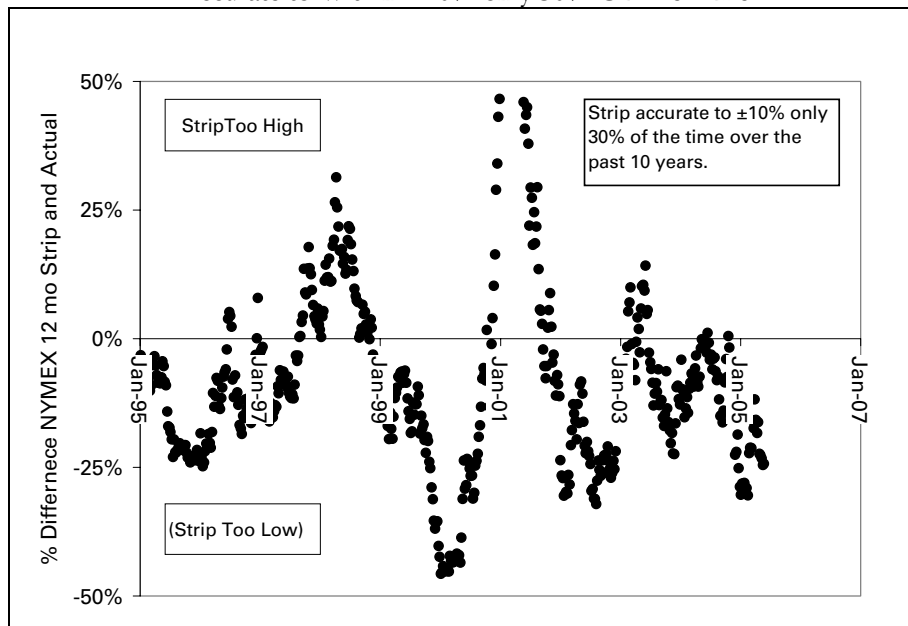
Onshore Production Growth – Offsetting GOM Declines
 Net Result is Aggregate Production is Flat



Sources DOE and Pickering Energy Partners

NYMEX futures...Do they tell us anything? As NYMEX prompt month prices have fallen in recent months, many have taken solace in the strength of the 12 months futures curve. Don't be lulled! A review of the 12 month NYMEX futures curve suggests it is not a reliable predictor of gas prices. Comparing 12 month prices for the past 10 years, the strip is accurate within $\pm 10\%$ only 30% of the time. It is $\pm 25\%$ wrong 20% of the time. The strip has been consistently low since early 2003...explaining the reluctance of E&P companies to hedge.

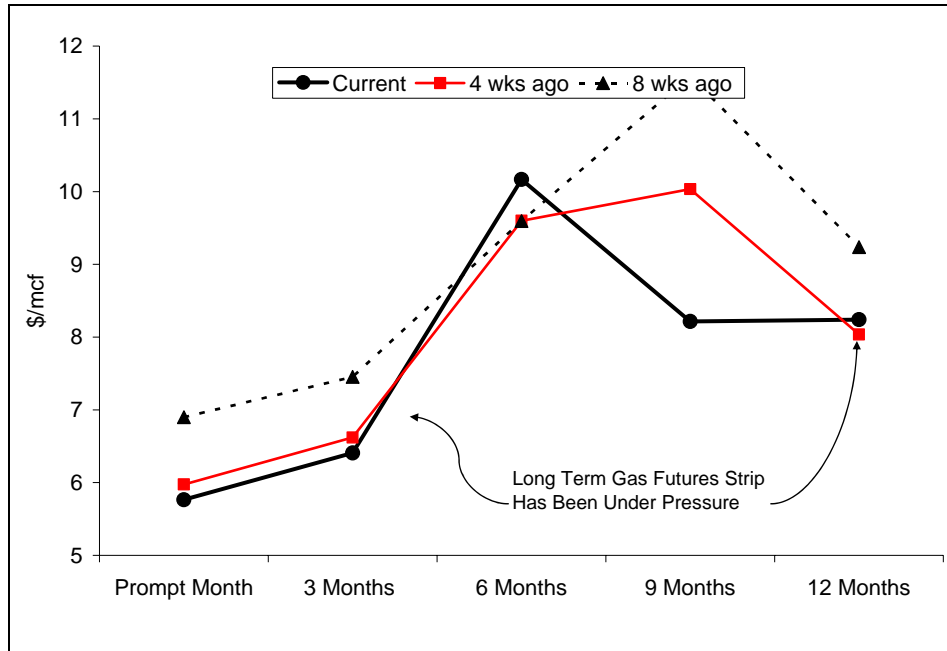
NYMEX Forward Curve Is Not A Reliable Predictor Of Price
 Accurate to Within $\pm 10\%$ only 30% Of The Time



Sources Bloomberg and Pickering Energy Partners

The recent 12-month strip (~\$8/mcf) has fallen in recent weeks. The question for the market: is the forward curve over or under-estimating gas prices? As the above analysis shows it is unlikely that the current futures curve is the right answer.

Recent Performance of NYMEX Natural Gas Futures
Weakness in Entire Curve



Sources Bloomberg and Pickering Energy Partners

Conclusion

Most signals continue to point toward a challenging summer natural gas market. Investors must keep their eyes on:

- storage levels,
- storage capacity,
- Onshore supply trends,
- weather adjusted storage, and
- regional price differentials.

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