



HORNSBY & COMPANY, INC.

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Energy Risk
Management Services

HIGHLY CONFIDENTIAL

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Good Morning

Overview

- Hydrocarbon prices were mixed overnight. **Crude oil up \$0.97 to \$40.53 per barrel; natural gas down \$0.001 to \$4.806 per mmBtu.**

News/Views

- Crude oil prices are managing to trade in a modest range either north or south of \$40.00 per barrel thus far this morning, waiting for a possible larger move until the announcement and details of the U.S. economic stimulus plan are released. This all continues to confirm in our mind that the non-commercial trader is alive and well, willing to buy crude oil assuming that a stimulus plan will stimulate oil demand in turn, leading to higher prices. We have assumed such behavior in our outlook, and probably should exaggerate it in order to appropriately capture volatility in any price forecast, despite the reality that oil demand recovery is likely to lack the rebound in economic activity. Despite lower prices, we do not believe that consumers will forget “how it was” only a year ago, consistent with our belief in a structural change in the path of world oil demand over the next few years. The implication of all this is that over the short term oil prices can achieve levels that will likely surprise the consensus, who will then tend to incorrectly extrapolate such trends going forward.
- Otherwise, OPEC Secretary General Abdalla el-Badri has been “talking the talk” lately, emphasizing compliance levels to date and expecting even better results for February. Aggregate OPEC volumes may in fact come down a bit more this month, but most likely due to a unilateral reduction by Saudi Arabia to reach our forecast sub-8.0 MMB/D average for the first quarter as opposed to ratable reductions by all members. More recently, however, el-Badri has been moderating his view of the March 15 meeting a bit, suggesting that while there is a chance that yet another output cut could be implemented, if crude oil prices remain at around current levels no action at all may be taken. This lies more in line with our expectations discussed yesterday, since under our view if OPEC can hold the current line through the second quarter, upward price leverage should be achievable.
- We have been discussing our scenario that crude oil traders would be selling March and buying April leading up to March contract expiration as Cushing stocks continue to build, and by and large this has panned out as expected. We should emphasize, however, that the contango has been

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compounded by index “rolls”. Indexes have attracted more interest recently because of the assumption that prices will rise over time and crude oil is a “bargain”, at least compared to where it was only a few months ago. The United States Oil Fund, LP (USO) for example, made some headlines by rolling a massive 80-odd million barrels recently, stuck with a contango that has severely impacted returns over the last few months in addition to the overall absolute decline in crude oil prices off the peak. This all compounds a situation that has helped make WTI the cheapest crude oil on the planet.

- Finally, we review briefly January gross cash refining margins for the United States as tabulated in our data bases utilizing representative refinery configurations for various geographical regions and crude oil prices. In a nutshell, on average last month witnessed a significant recovery in margins relative to the fourth quarter as refiners continued to try and adapt product output and yields to lower demand. The largest recovery was on a WTI basis, as theoretical as it might be, due in large part to the weakening prompt month as well as stable product prices. The Midcontinent margin more than doubled from depressed fourth quarter levels. Looking at a Gulf Coast margin running Mars crude, our numbers suggest a near-20% improvement in January over the fourth quarter, from roughly \$10.50 to \$12.50 per barrel. On the West Coast, a representative ANS margin improved from about \$12.00 per barrel to more than \$18.00 per barrel.