HIGHLY CONFIDENTIAL
February 18, 2009

Good Morning

Overview

- Hydrocarbon prices were mixed overnight. **Crude oil up $0.24 to $35.17 per barrel; natural gas down $0.037 to $4.166 per mmBtu.**

News/Views

- After days like yesterday in the equity market there is little to offer that will provide any comfort. Further evidence that economic malaise at best, and severe recession at worst, is spreading more evenly throughout the world lends itself to down days to the degree we experienced yesterday, and perhaps Tuesday's S&P drop was indeed the other shoe we have been looking for. It certainly fell within the magnitude of expectations. The decline happened to correspond with March crude oil options expiration, with the settlement close to the "nice round" number we were expecting of around $35.00 per barrel. Thus far, therefore, prompt WTI is trying to seek its trough around this "bogie", and not $30.00 per barrel. There is no technical evidence yet of a bottom to the crude oil market, however.

- We are still looking for a more attractive opportunity in the outer months, and yesterday's term structure action moved us closer to reasonable numbers from the standpoint of risk versus return. Before we would consider issuing an official "buy" on crude oil, however, we would wish to see a contract like September, for example, trading closer to $40.00 per barrel. This would not necessarily be achieved only by the prompt month falling to $30.00 per barrel or below, since a number of factors could work toward flattening the curve to the sufficient degree, leading to little change in the front month but further weakness "farther out".

- One of these factors is clearly the weekly DOE stats for the week ending February 13, delayed for release until tomorrow morning, with the API numbers released this afternoon. The latest Platts survey is looking for a 2.5 million barrel build in crude oil stocks, a 1.0 million barrel gasoline draw and a 1.5 million barrel decline in distillate inventories. The rationale given for the crude oil build is the assumption of a modest cut in refinery runs. Our cursory cut at the numbers would suggest a somewhat larger crude oil build than the consensus is looking for. We had previously discussed our expectations that before all is said and done, there was scope for crude oil stocks to build somewhat more, both in the aggregate and at Cushing, before effective shell capacity is reached. We estimated that in the case of the United States as a whole this number would be roughly 355.0 million barrels with Cushing capacity currently standing at around 38.0 million barrels. There are projects under way to expand capacity at various locations under the assumption that the market contango will continue, but we have not assumed completion of such projects during the course of the second quarter. With regard to tomorrow's numbers for refined products, we would expect a bit larger gasoline draw but a somewhat smaller distillate stock decline than the market is looking for at the present time.

- Otherwise, we remain in the process of finalizing our earnings expectations for the industry for 2009, and within this context toward publishing our report on our "subsector" of the major international integrated oils later this week. Under our Base Case hydrocarbon price assumptions, the quarterly peak in price is expected for the third quarter. By that time, although we are now the only ones on the planet that believe so, we will be seeing tangible signs of stabilization in the manufacturing sector. This combination when integrated into both upstream and downstream earnings for the companies implies that peak quarter earnings will also come in the third quarter. From a trading standpoint only, therefore, we are inclined to think that a reasonable valuation approach would be to annualize our third quarter earnings expectations and assign a reasonable multiple in order to determine stock price targets for the next few months. This may seem like grabbing at straws in an economic hurricane with overall equity market moves even more influential on individual stock prices almost irrespective of the sector, but we believe in the final analysis our approach is reasonable, particularly if it ends up that the consensus is indeed too conservative with regard to oil and gas prices for this year.

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W.H. Brown, III