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Energy Risk
Management Services

HIGHLY CONFIDENTIAL

February 27, 2009

Good Morning

Overview

- Hydrocarbon prices fell overnight. **Crude oil down $1.13 to $44.09 per barrel; natural gas down $0.029 to $4.048 per mmBtu.**

News/Views

- Yesterday was yet another session where hydrocarbon markets diverged from a sagging $&P 500, with the RBOB rally continuing into a second day and crude oil supported by both a technical move to the "nice round" number of $45.00 per barrel as well as confidence that OPEC means business. Back in January we discussed how a $1.00-$2.00 per barrel July RBOB crack represented good value irrespective of the recession given refiners' ability to manage yields in a weaker demand environment. Ultimately the market agreed with us, with the July crack settling at more than $8.00 per barrel yesterday.

- The OPEC side of the coin is coming as a surprise to many, with lower deliveries moving into February the result of both weaker demand and proactive allocation by members, including a couple outside the Arabian Gulf. A few months ago we suggested that because Saudi Arabia in particular sells only to refiners and not independent traders, the Kingdom' volumes would be among the first to come down as refiner requirements declined and Saudi Aramco allocated crude below nominations. We suggested it would likely be Iran who would lag the trend, given their willingness to sell spot barrels to traders. The tanker storage demand given the market contango would support such incremental sales until storage demand was fully satisfied. It appears we were reasonable in our assessment, since through January it did not appear that NIOC had curtailed any volumes. However, Petrologistics reports that February exports may well decline by 300 MB/D or so from January, suggesting that tanker storage had peaked, in line with our unfolding Base Case. This would suggest a first quarter Iran production level perhaps averaging some 3.5-3.6 MMB/D, in line with our assumptions.

- Today may be a good "stress test" to see whether crude oil can remain independent of the equity market. Thus far this morning, we are not surprised to some retracement in crude oil given the two-day run up. In addition, after the NYMEX settlement yesterday the S&P 500 continued to fall, leading to a post-settlement decline back below $45.00 per barrel which is feeding a bit on itself as we issue this note. The market will face fourth quarter U.S. GDP data today which, although ancient history, could set the tone for the short term. In terms of where all this fits into our Base Case price scenario presented in January, back then we suggested that prompt WTI would average around $42.20 per barrel in February.

- Depending on today's action, it appears that February will actually average about $38.75 per barrel. The shortfall was due to inordinate prompt weakness reflecting the contango trade, the index roll impact from USO and others, and Cushing stocks building somewhat more than expected. The key as to whether WTI is destined to experience a seasonal recovery or not will be March. Our forecast pegs prompt WTI next month averaging more than $47.00 per barrel. This had assumed that gasoline continued to "do its thing" and that the crude oil term structure would "flatten" somewhat in response to what we believe will be a peak in crude oil stocks. If we are wrong and too optimistic, however, it will likely be because traders will jump on the contango trade once again and sell April and buy outer months ahead of the index rolls. For 2009 as a whole, as discussed in our monthly reports prompt WTI is expected to average about $55.80 per barrel, incorporating both our fundamental outlook and our estimated impact from financial players and variables. For comparison purposes, our models suggest that based on fundamentals alone, prompt WTI "should" average around $47.60 per barrel this year, implying that our quantified financial impact will add more than $8.00 per barrel to fundamental value.

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