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Energy Risk
Management Services

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Good Morning

Overview

- Hydrocarbon prices were mixed overnight. **Crude oil up \$0.36 to \$49.98 per barrel; natural gas down \$0.018 to \$3.391 per mmBtu.**

News/Views

- Crude oil remains resilient to the notion of excess inventories for the time being, continuing to trade with equity markets. There has been some commentary in the media that in previous recessions crude oil has traded substantially lower than current levels. No kidding. In the depths of the Asian financial crisis more than 10 years ago prompt WTI settled several times below \$11.00 per barrel. We have previously discussed within the context of our "layered" price analysis that under pre-2004 relationships between NYMEX crude and days supply of U.S. inventories, prompt WTI "should be" trading at less than half current values. The point is these are not the "olden days" any more. The underlying non-commercial activity in crude oil trading, for better or worse, has raised the bar for the time being and the foreseeable future, in addition to fundamental factors we have long indentified including costs, but particularly the secular decline in Atlantic Basin light crude oil availability. On the other side of the coin, however, we also hear commentary to the effect that funds are buying oil as a "safe haven". Anyone who has traded crude oil for an extended period of time recognizes this characterization as almost laughable given the inevitable volatility, which admittedly is decidedly lacking at the present time. A weaker dollar is also re-emerging as a justification for buying crude oil, as previously discussed. Based on yesterday's dollar/euro rate, however, prompt WTI "should be" trading at around \$58.00 per barrel, all else equal, which of course it is not.
- Otherwise, after sagging for most of this month in contrast to the drilling/service sector, the integrated and producer equities demonstrated a bit of life yesterday, in part in response to first quarter earnings for companies such as ConocoPhillips and Oxy that came in somewhat above consensus expectations. We hope this characterizes the group as a whole, with the market then turning its attention to the second half of the year when we envision, right or wrong, an improving operating environment. This industry has a tendency to cut costs more than most analysts anticipate under difficult conditions, and we ourselves are encouraged by somewhat stronger than expected upstream profitability given first quarter hydrocarbon realizations. In COP's case, for example, our Base Case yields 2009 operating net income of \$3.80 per share, above consensus.

In terms of the downstream sector, however, we noted some comments on yesterday's Conoco call that were worth pointing out and of some concern. The company indicated that in the second quarter, refinery operating rates would be much higher overall, with an anticipated rate in the United States in excess of 90% capacity utilization. While U.S. run rates naturally rise in the second quarter, under the weak demand environment such utilization rates would preclude any margin improvement on the refining side. The company conceded that there was some economic component to the run rate forecast, but was not specific nor would indicate what would happen to runs if margins indeed faltered, even with turnarounds outside the United States limiting the overall company run increase. In this context, we took the company's U.S. capacity utilization target for the second quarter and assumed it applied to the entire industry. Our Base Case has assumed that second quarter U.S. refinery capacity utilization will average about 85.3%. If we plug in an average, say, 91% utilization rate,

assuming net crude oil imports remain the same as under our Base Case, at the end of June U.S. crude oil stocks total only 270.0 million barrels, some 100 million barrels below current levels. No surplus, no more. The problem is that under our demand assumptions for gasoline and distillate during the period, at the end of June primary gasoline inventories total about 250.0 million barrels, grossly bloated and some 33 million barrels above current levels unless the U.S. becomes a major net exporter. Distillate stocks end the second quarter at about 160.0 million barrels, almost 18 million barrels above current levels, unless the U.S. sends every incremental barrel of output to China. Our point is that “this dog doesn’t hunt” as our Southern friends say, and in the final analysis industry operating rates in the second quarter are unlikely to be this high, precluding product stocks from bloating further, but also preventing any major drawdown in crude stocks until the second half of the year, as we have assumed.

W.H. Brown, III

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