HIGHLY CONFIDENTIAL

March 25, 2009

Good Morning

Overview

- Hydrocarbon prices fell overnight. **Crude oil down $1.13 to $52.85 per barrel; natural gas down $0.032 to $4.315 per mmBtu.**

News/Views

- For a good part of yesterday crude oil followed the equity market around, with all waiting to see whether there would be any follow-through to the previous day's surge in the S&P 500. In the final analysis, equity profit taking characterized the session, not surprising in the least. On a settlement basis crude oil was up on the day coinciding with an intra-day recovery in stocks, but the reason was due primarily to a sympathetic gain with products from word of refinery shutdowns and less to any indication that crude was beginning to demonstrate a broad, fundamental independence from financial variables. Total announced that it was shutting its 180 MB/D Port Arthur Texas refinery for undisclosed work, but well-founded rumors suggested it was due to poor margins. In addition, Valero is keeping its 20 MB/D FCC Corpus Christi unit offline for similar reasons.

- These "real" fundamental phenomena lend further support to our contention that the recent recovery in hydrocarbons has been financially driven, led by WTI. Crude oil is the hydrocarbon of choice for funds due to liquidity and the assumption it is the proxy for all things fundamental, which on a short-term basis at least it is not, particularly when one is trading WTI. If we look at the trend in refining margins over the last few weeks the data reveal the decoupling between crude oil and refined products. Refiners have done a good job in managing yields and runs to handle lower refined product demand, but there are limits when crude oil rises to the extent and velocity that it has while demand remains weak in the context of excess refining capacity.

- To quantify, on a hypothetical basis running WTI cash Gulf Coast margins have declined from about $12.50 and $13.00 per barrel in January and February respectively to $5.60 per barrel March to date. However, on a more representative basis, running a sour crude such as Mars on the Gulf Coast yields a more consistent trend. That is, from an average cash margin of almost $12.60 per barrel in January, margins fell to $8.80 per barrel in February and $7.00 per barrel March to date. The more consistent trend results from an overall rise in crude oil prices with traders trying to arb the difference between WTI and Mars, the reduction in sour crude oil imports reflecting lower sales by Saudi Arabia, and the lack of the depressed prompt month that characterized WTI for much of the first quarter due to rising Cushing stocks. In general, the decline in margins from January to date has characterized running other crudes in all regions in the U.S. coast to coast. Overseas, margins likewise have dropped over the period, particularly as reflected by our Singapore model running Dubai crude, where on a cash basis margins have recently turned negative. Dubai has also firmed relative to other grades reflecting the reduction in overall Arabian Gulf sour crude oil availability.

- Thus, we are seeing clear demonstrations of our argument that in order to achieve our Base Case crude oil price forecast, a combination of *both* financial and fundamental variables all working in the same direction are needed to pull prompt WTI toward $70.00 per barrel by August. We have seen clear evidence of the potential financial leverage on price, but as we have previously discussed a further requirement is that crude oil stocks begin declining, while refined product demand begins to stabilize on a global basis in the second half of the year. In terms of crude oil stocks, it may yet be premature to assume we are at the anticipated inflection point, which we would be looking for mid-to-end-second quarter. In this regard, the API reported last evening that crude oil stocks for the week ending March 20 rose by a hefty 4.577 million barrels, well in excess of consensus expectations reflecting low runs and higher imports. We would reserve final judgment until the DOE stats are released due to frequent discrepancies on a week-to-week basis. DOE-surveyed stock levels are already not far from what we estimate to be effective U.S. shell capacity, while the API has been “catching up”. The API reported that product stocks, however, fell more than expected. If on a DOE basis the crude stock change is minimal but product stocks decline, prompt WTI has a chance of resuming a modest uptrend, particularly if the S&P 500 resumes its “bear market” rally.

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