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Energy Risk  
Management Services

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**HIGHLY CONFIDENTIAL**

January 29, 2009

**Good Morning**

**Overview**

- Hydrocarbon prices weakened overnight. **Crude oil down \$1.01 to \$41.15 per barrel; natural gas (Mar) down \$0.060 to \$4.360 per mmBtu.**

**News/Views**

- Crude oil managed to mount a modest recovery yesterday, aided by constructive product stock data from the DOE, a surging equity market, and a disruption from the Osage pipeline linking Cushing to Kansas refineries. Nonetheless, as we anticipated the contango has begun to deepen again despite the modest gain in absolute prices, and we suspect the market may decide that the so-called stimulus package is no universal panacea for weaker oil demand, particularly as Cushing and crude stocks overall continue to build.
- Otherwise, we wish to lay out some thoughts with regard to factors causing crude oil price seasonality as a follow up to yesterday. Once again, a primary reason why crude oil prices weaken in the first quarter is the market discounting the expectation that once winter is over, oil prices will decline in line with the first to second quarter seasonal downturn in world oil demand. Every year analysts and OPEC ministers worry about it, and markets embrace these concerns via weakening prices well in advance. Another reason is reduced seasonal demand for crude oil in the visible Atlantic Basin as U.S. refiners anticipate upcoming turnarounds. More important from our standpoint, however, are the factors that account for the potential *recovery* in crude oil prices in the second quarter following the first quarter trough. First off, while it is true that world oil demand falls from the first to second quarter, the reason is obviously the decline in heating oil/gasoil demand. The demand for *crude oil*, on the other hand, is relatively flat due the variability in global turnaround timing but, more importantly, *rises* in the visible U.S. market as refiners emerge from turnarounds.
- Another reason why prices firm is the seasonal reduction in North Sea production reflecting routine platform maintenance. One of our primary arguments over the last several years has been that the consensus was too bullish on non-OPEC supply gains because the North Sea was witnessing a major secular decline in production. These Atlantic Basin crudes are also highly visible, and given the overall lower production rates any further reduction due to platform downtime has a multiplier impact on light crude oil prices such as WTI. Another crude-oil specific factor for potential seasonal price recovery is OPEC. While markets firmed on words from Davos that OPEC compliance is progressing nicely, our balances suggest the most important period for compliance to induce a global crude oil stock draw is the second quarter. Such a continuation of reduced volumes through June **will have a larger potential influence on price this year than at any time in recent memory.** Product-specific factors that help pull up crude oil prices center primarily around the U.S. gasoline market. The seasonal rise in gasoline demand and gains in margins provide support for crude oil. As important, however, is the non-commercial response to rising refinery runs. When refinery capacity utilization is relatively high, funds are more likely to buy gasoline, providing additional underlying support for the hydrocarbon complex overall, under the assumption that prices will spike, thus generating “excess returns”, given any unanticipated disruption in refinery operations.

Where do we stand on these factors for 2009? With regard to the crude oil factors, we believe that **the seasonality in North Sea production combined with OPEC “discipline” will have the most influential impact on price.** While gasoline demand will rise seasonally, our long-standing balances have called for a further decline in gasoline demand in 2009 of about 1.5% or so, and thus the seasonal demand rise in absolute terms will be muted. The same will be true for the seasonal rise in U.S. crude oil demand, since our balances suggest that refiners will keep crude oil runs some 500-600 MB/D below the customary summer peaks relative to recent years. Funds in turn will discount a lower refinery capacity utilization rate, and therefore will not bid up gasoline prices to the extent otherwise given the implied reduced odds that a disruption in operations will have a sustainable impact on price. On balance, our Base Case crude oil price outlook will assume *some* seasonality because we do not believe global oil demand will deteriorate to the extent of consensus expectations, but it will be muted compared to the last few years due to the impact of weaker U.S. gasoline demand. Tomorrow morning we hope to quantify all this via our WTI price forecast.

W.H. Brown, III

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