Could History Repeat Itself in 2014-20

By Pat Thornton, Marty Lerum, and Jeff Thompson

As we talk to retail propane marketers, one question that keeps coming up is, "Could we have another winter as bad as last winter?" While many who have been in the industry for decades like to say last winter was a "once in a lifetime" winter, they still have concerns. There are many factors in play this year that bear an ominous resemblance to last year.

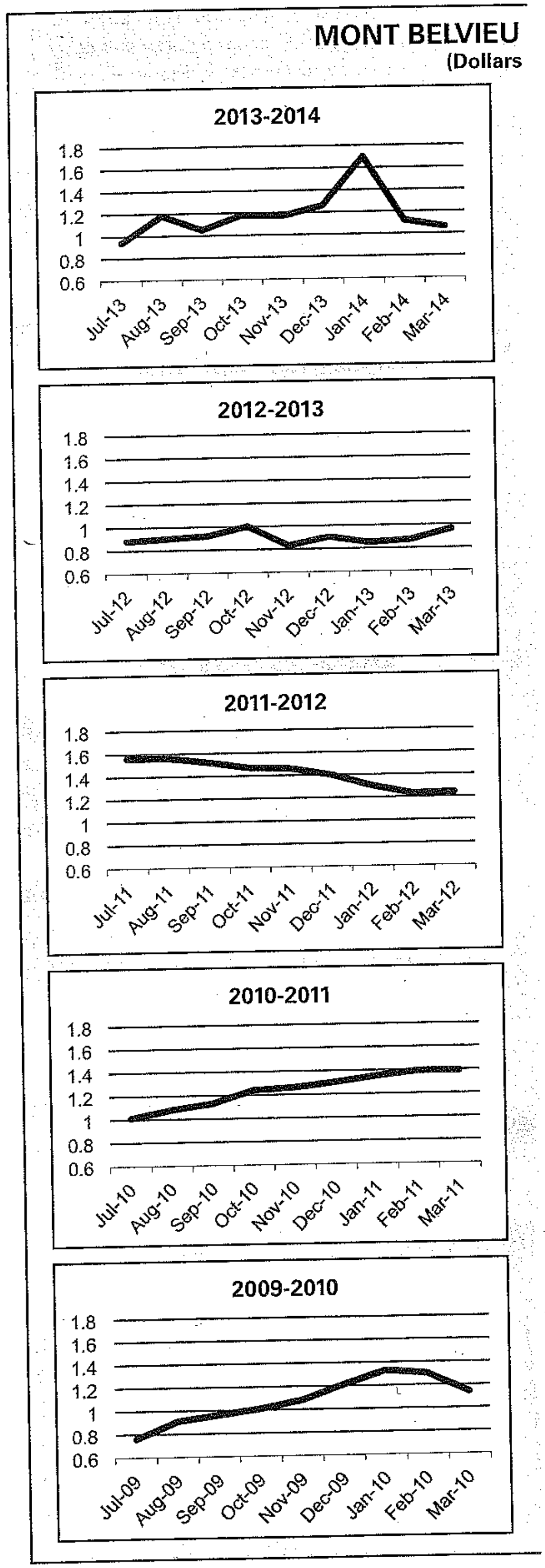
With retail propane marketers often consistent about implementing the plan that would have worked perfectly the previous winter, this season *could* turn out to be a non-event. Nonetheless, many factors suggest this is certainly a year to follow through with every bit of preparedness that was necessary last year.

At this time last year, we were concerned that prices could easily move up to the world propane market price during the winter, which was considered to be in the $1.45/gal. area then. That certainly did happen, and then there was the shortage in the Midwest that caused the massive price spike to $5/gal. following shortly thereafter. This year a very similar scenario is setting up. As of mid-July, we are 5 MMbbl ahead of last year during the same week. With export capacity even greater than last winter, we could easily see prices move up to the $1.45 area regardless of crop drying or winter conditions. The Midwest is still prone to the challenges we saw last winter, and even if the huge price spikes don't happen, we would certainly prepare for a move up to the world market.

Export capacity has more than doubled, from 200 MMgal. a month in January 2011 to 525 MMgal. in January 2014. That capacity is on track to continue growing, and by 2016 we may be able to move the entire amount of U.S. propane production out of the country. Along with increased exporting, the supply infrastructure is evolving to be able to move more gallons from U.S. shale plays directly to the Gulf Coast faster. This means pipelines that once shipped north now ship south. It means gallons that only two summers ago were virtually trapped at Conway now flow easily from there (or around Conway) to the Gulf Coast. These changes were a huge reason for the difference between 50-cent propane in the summer of 2012 and $5 propane in winter 2013-2014.

With exports flowing at a rate of 12.5 MMbbl a month, we are prone to price spikes even in a normal winter. The infrastructure changes at Conway have inventory there significantly lower than at Mont Belvieu. At Conway in June we saw just one-fourth of a typical June build. With Conway volumes at 20 MMbbl in mid-July (just 1 MMbbl above last year), Mont Belvieu volumes at 35 MMbbl (just 3 MMbbl above last year), and the Cochin pipeline from Canada no longer shipping propane into the Midwest, the Midwest supply points will be challenged again this winter, even with normal demand.

So, history may not repeat itself to the extreme we saw last year, but there are enough similarities to be concerned about price spikes, to some degree, in the U.S. Heartland. We've had some surprise builds that have helped us to get above 60 MMbbl well ahead of October. The switch to ethane and butane by the petrochemical industry helped make more propane supply available. Production has continued at a healthy level, especially in the Marcellus and Utica shale plays. Keep in mind, however, that we entered last



5? Let's Hope Not, But Be Prepared!

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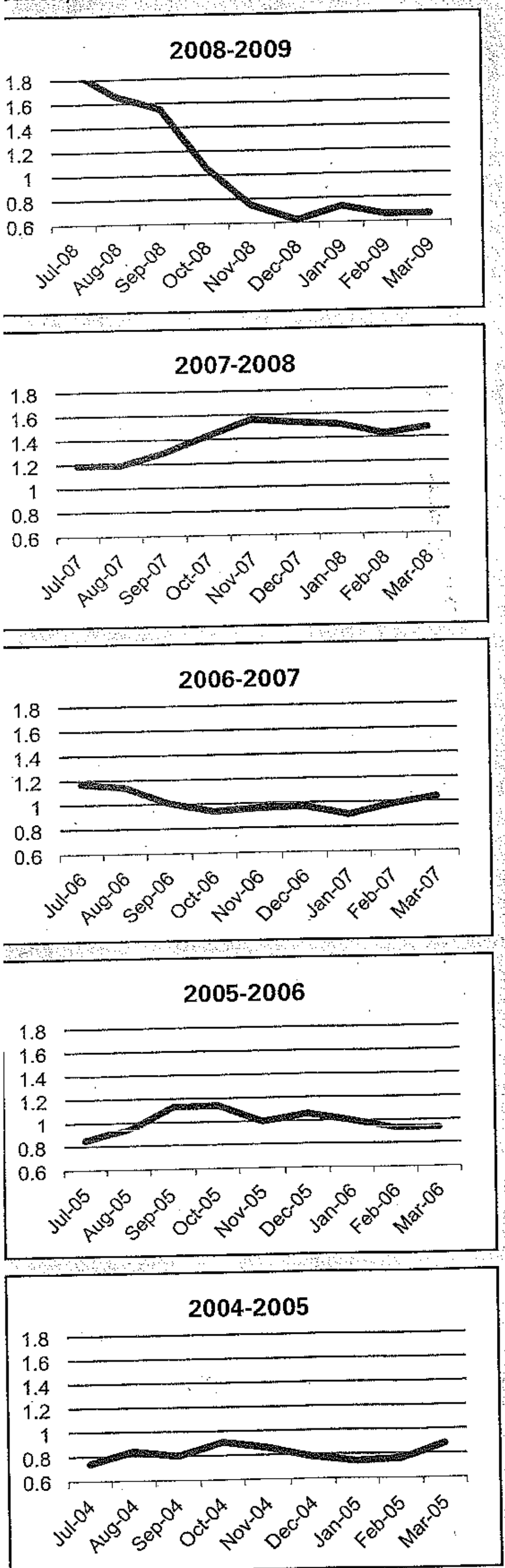

October at what previously had been an extremely healthy level—67 MMbbl.

Most marketers are taking action to be more prepared than they were last year. They are being much more diligent about covering sales with pre-buys and hedges. They are finding more reliable suppliers. They are paying attention to earning allocation where they need it. For some, this has meant a major overhaul of the winter planning process. Suppliers who did not perform well last winter have been replaced by suppliers who came through for their customers. Retailers are becoming much more aware of who stores product at sites in close proximity to their location, and locking in their wet gallons with them.

The concept of locking in an index price to Mont Belvieu or Conway is also making more sense to retail propane marketers. This type of agreement makes the marketer less likely to be affected by regional price spikes, and it allows for hedging with contracts at Belvieu and Conway. In many cases last season, the index prices were more than a full dollar under rack prices. At a time when many marketers were unable to get delivery of their pre-buy gallons, the hedges at Mont Belvieu and Conway could be sold off at huge premiums, while gallons were lifted from differential contracts.

Retail propane marketers have also explored the need for more storage. Of course, this represents a capital expenditure. But, consider that having one-sixth of total winter volume—October to March—available in your own storage is a good plan. Keep in mind that while storage is an added expense, the value of tanks typically appreciates. It also adds to delivery efficiency to have tanks strategically located throughout your market area.

Another issue that many revisited is whether or not to buy their own transport truck. While the security is nice, there is a high cost. Factors to consider include how often the truck will be used, the distance to your main wholesale supply points, and whether you are committed to pay the driver year-round, or just on a seasonal basis. The fixed and variable costs of owning and maintaining a truck, and paying a driver, add up to a substantial amount of money. Take them all into account and weigh them against the freight costs you have been paying before making a decision.

Allocation was a huge issue for retail propane marketers last year. Earning allocation for the winter is critical to make sure gallons are available during the high-demand winter months. Retail marketers are more keenly aware of the need to lift as many gallons as possible during the April-to-September period, and to make sure these loads are earning them allocation for October through March. This means doing as much as possible to fill customer tanks throughout the summer months. Customers should have an economic incentive for taking gas in the summer. Budget-pay programs that allow them to pay year-round make customers much less concerned about keeping the tank full, regardless of how soon the gallons will be used.

Being prepared entails having the gallons arranged and available at a nearby location throughout the winter season. Whether index or pre-buy gallons are arranged, they need to be accessible. Locking in margins is, of course, critical. Anything that is sold at a fixed or capped price should be covered with a pre-buy or hedge.

As mentioned, Conway is most likely to move up strongly again

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Winter Repeat

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this winter. It would not be surprising for both Mont Belvieu and Conway to climb closer to the world propane market price this season. A look at the *propaneprice.com* monthly averages for Belvieu over the past 10 years shows prices went up from July to September seven of those 10 years. If they were higher than July in September, they were also higher in December and March. Likewise, for the three years they were lower than July in September, they were also lower in December and March.

Based on the past 10 years, prices in the ranges we are currently experiencing will likely rise through to September (when most cover fixed programs) and will stay stronger through the winter season. Therefore, the likely best time to cover positions is now, if they are not already covered.

The U.S. government has at least taken one step toward being more prepared. The passage of the Reliable Home Heating Act clarifies that the Federal Motor Carrier Safety Administration must accept hours-of-service extensions during emergencies declared by a state governor for up to two additional 30-day periods, for a total of three. The bill also allows for governors to be notified if their district's inventory of residential heating fuel has been below the most recent five-year average for more than three consecutive weeks. This should help state and federal authorities to be aware of potential supply challenges before they become critical.

We have to believe that the experiences of last winter will allow for quicker action by the Federal Energy Regulatory Commission to require pipeline operators to prioritize propane shipments when needed. Last winter, the critical need was for propane from the Gulf Coast to move expeditiously to the Midwest. However, there was almost a month between the identification of the severe shortage and action to move the gallons. While headlines and screaming consumers get the attention of members of Congress, it is amazing how long it still takes to get action. Surely, with the lessons learned last winter, necessary action will now happen faster to alleviate critical needs and minimize price spikes.

Additionally, there is plenty government officials can do beyond being better prepared in the previously mentioned areas. Approving the Finger Lakes storage in New York, allowing exemptions to the Jones Act to allow propane to be shipped between U.S. ports on other than American-made vessels, and more transparency about commodities shipped on pipelines, are key steps that would further improve our supply and distribution system.

Regardless of government action, the retail propane marketer needs to be prepared. Covering gallons adequately, building a supply portfolio that guarantees margin protection, being comfortable that contracted gallons will be accessible, communicating with customers, and offering pricing options that fit customers' needs are all steps retail marketers need to keep in focus.

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