When the Music Stops...

By J.D. Buss

If you had storage space, wheels, and access to the Chicago market, Christmas came early last July. That was when cash prices for propane dipped to below 40 cents/gal. and prices were posted at values 10 cents/gal. or more below Conway. To some, it almost felt like stealing, but certainly no one felt guilty enough to walk away from such a value. During the mid-point of summer, Chicago-area propane was priced to move up to 400 miles away. And it did.

The aftermath of "red July" has left an indelible mark on the propane industry. From a historical standpoint, it represented a return to the pricing of yesteryear. Going back to those good old days has prompted thoughts in the retail sector that the scenario can, and will, give a repeat performance in the current or future years.

Taking a look at the fundamental shape of the propane industry, it can be hard to argue against this view. Production levels are soaring as Energy Information Administration (EIA) statistics place daily propane production at 1.3 MMbbld or higher for 2013. Fractionation capacity has become the hot and rare new commodity as mix and y-grade product flow freely from natural gas fields. Even a glance at U.S. inventory levels, while depleted from prior-winter record highs, have still remained at or above the five- and 10-year average marks.

But no argument is ever that concise or clear-cut. Both sides of the propane market—demand and supply—are viewing the same data. The former views the data through a lens of advantage and simply holds to the advice, "be patient;" the latter sees loss of value and knows time is not their friend. It is the strategy choice of the latter—supply—that should be closely observed by the retail sector.

In both a backwardated market—prices gradually decreasing—or in a high-supply market, selling early tends to achieve some of the best results. Suppliers know this and seem bound not to be the last man standing during 2013.

The first wave of this new selling early trend took place early this year, before the end of the prior winter season and well before the traditional conference season kicked off. Plus, the new trend has proven to have a trickle effect this year as it moves from the Northwest to the east.

Canadian producers, along with some Bakken production, started this off with heavily discounted propane on term deals for the 2013-2014 season. While a very strong first move, this wave only started to ripple through the market in the form of term rail deals that moved supply to eastern regions of the U.S.

A cold and lengthy winter season allowed some of this first supplier trend to go a bit under the radar as retailers scrambled to simply stay "wet" in the current market. Start of second quarter and the hunt for other supply deals in the Midwest began to reveal the full nature of this growing supply trend. Terminals that had seen differential levels of double digits in prior years were now seeing term deals that were sometimes 50% cheaper. Refineries that had been able to supply summer gas at a small premium above the Conway and Belvieu hubs were now offering minus values. In a few short weeks the wave of supplier discounts was starting to surge.

For those who spend every day analyzing and studying the market, questions were flying: Is this the new nature of the market? Are some suppliers simply playing games? Am I missing some important piece of data? The complex nature soon became condensed to the simple—suppliers did not want to be left without a seat when the music

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stopped. This new trend seemed to confirm the oversupply data and theories that were swarming around the market for months on end. After enduring deep discounts the prior year, suppliers resolved to take aggressive means to avoid that scenario again.

What's this mean for retailers? First, your annual cost structures should be improving from prior years. But don't wait on the sidelines too long. Prices for term deals, whether by truck or rail, have both increased in price from the early offers on the table. Second, don't be surprised if a supplier "oversells" product. This phenomenon is not unique to the propane market. Have you ever been offered coupons or monetary incentives to give up your plane ticket on an oversold flight? With lower sales prices and more product pumping out of the ground, there can be a temptation for a supplier to stretch for extra value any way possible.

The last item that retailers should be considering with these market changes has been, and remains, storage space. An argument for storage appears a bit counter-intuitive given supply increases and rising storage costs, but there are some important factors to keep in mind.

Supply may be increasing but production levels still do not mirror retail demand. Lowering your summer-to-winter ratio may create price advantages when looking at term supply. Abundance of supply may also provide discount opportunities during low-demand periods. Conversely, market inefficiencies that create price spikes in the cash market are typically short-lived, and owning storage allows a retailer to make the most of those opportunities. The age-old mantra of "back-up supply" is still a solid reason to hold storage space, and those that held on to storage gas during price spikes will also receive strong returns on their investment.

Fundamentals of the propane market are changing. The retail segment has seen, and could continue to see, benefits from this overall shift. But suppliers are also changing their operations. Understanding and planning for these changes will help the retail sector be well positioned to not just weather, but succeed, amid these market shifts.

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Hedging/Fixed Price Protection for Winter

Get started with a small history lesson on market movements over the last four years. Start the review looking at crude values (WTI):

1. Every spring since 2009 EXCEPT for this year, WTI prices have rallied during the February to April time period.
2. Over the last three years, the month of May has seen the following price drops:
   a. 2010 – a $23/bbl drop from High to Low
   b. 2011 – a $20/bbl drop from High to Low
   c. 2012 – a $20.50/bbl drop from High to Low
3. In the last four years, the only May to see a price INCREASE was in 2009 with a net rise of $16/bbl.

The next market we'll look at is propane, and specifically review the Belvieu market.

1. During the February-April period for the last four years, Belvieu prices have been down 3 out of 4 years and up in one.
2. Activity during the month of May for last four years:
   a. 2009 – went up 13 cents/gal.
   b. 2010 – went down 16.5 cents/gal.
   c. 2011 – went down 11 cents/gal. (but was flat/relatively unchanged for much of summer)
   d. 2012 – went down 38 cents/gal. from high to low

As we moved into May 2013, we found ourselves asking the question, Will history repeat for both commodities or will we see a new trend take place? History shows higher odds of a downswing. Looking at current market situations, the analysis does not seem nearly as clear cut.

Crude prices were sitting right at a tipping point, in the $89-$91/bbl range. Why is this a tipping point? The $89-$90 range represents the 50% retracement of the massive 2008 fall in crude. From January 2013 until early April, the $89-$90 range has been the strongest crude price support. Not only has the $89-$90 range been a support for almost four months, prices have been in a very tight $9-$10 band for that same time period. Finally, from early 2009 through April, there has been a solid up-trend line that has supported prices and is positioned now very near the $89 threshold.

Anytime markets are near or at a tipping point, there becomes an anticipated strong move—either up or down. Right now crude and propane may be staged for that type of move, especially given the dramatic movements that have taken place in May during prior years.

In light of possible strong swings coming our way, how do we prepare? How do we protect winter margin? First, look at comparable cost levels. Now versus 12 months ago, prices are roughly 20-30 cents/gal. lower for winter deals. If that fits into your sales price and margin estimates for this year, it may be a good opportunity to get some protection. Those with zero protection and believe these cost levels work are recommended to look at hedging 10%-20%. Those with some protection already, and believe these cost levels work, should look at another 10%-20%. Overall, it is recommended to be in the 30%-40% range at most (definitely not above 50%).

For those with a "wait and see" outlook, be ready, willing, and primed to make a big purchase in case prices start to surge higher. For either the "wait and see" or those with current protection, be ready to sell existing winter positions in case prices start to drop like a rock and repeat history.

We currently believe propane supply is abundant and growing faster than potential demand. Therefore, lower prices are anticipated. But markets do not always react as anticipated, so we are preparing for multiple scenarios. As always, every business is different, and it is important to discuss and evaluate to determine impacts on individual winter portfolios.