Hug Your Trucker, and Expand Storage You Control

By J.D. Buss

A mantra has been chanted in print and broadcast market analyses this past summer—Secure Your Propane Supply. The Minnesota Corn Growers Association urged farmers to "plan ahead for their propane needs." Iowa agriculture secretary Bill Northey advised farmers and homeowners to "fill their tanks before cold weather arrives or contract supplies at lower prices beforehand." Calls for a strategic propane reserve were echoed by the governor of Wisconsin. The Propane Education & Research Council (PERC) was advocating that farmers plan ahead and consider buying more efficient grain dryers. That plan-ahead message extended to propane households, with PERC urging consumers to work with their propane provider to establish a winter heating season supply plan.

A casual observer might quickly look at these calls to secure propane and surmise that either demand is on a record growth path or that supplies remain woefully low. However, neither is accurate, and the truth may lie in a review of two abundant commodities that have seen record production growth in the U.S. recently.

Propane and Natural Gas

One article (on McClatchy DC, *www.mcclatchy.com*) this summer made this statement about propane: "Long a niche in the energy sector, propane today is sexy." Market interest in propane has definitely increased, but before propane got all the attention natural gas was the rage. From late 2004 through the end of 2008 natural gas prices rarely traded below $5/MMBtu, and commodity prices hit highs near $16/MMBtu. Surging natural gas values boosted U.S. production, which in turn generated a rising tide of natural gas liquids, propane being a key component.

Fast forward almost six years and we now see strong production levels of both natural gas and propane. Pull up a forward-price curve for either commodity and we see extremely tight price differentials between current-month and prices 12 to 24 months in the future. Implications from these statistics are twofold: there is limited economic incentive to store either product, and future supply should be plentiful. Yet these are not the sentiments being expressed in the propane industry, at least in the retail sector.

As of mid-summer 2014, total U.S. propane inventories stood at just over 65 MMbbl, with easily another eight to 10 weeks left in the build season. If those current propane inventory build levels continued, inventory could have reached a first-time-ever 80 MMbbl. Natural gas inventory levels, however, were 500 Bcf below last year and nearly 700 Bcf below the five-year average. Those scenarios for both fuels provided limited economic incentive to store product based on price curves. But despite that similarity, further comparisons between the two fuels see the markets diverging.

Fear Factor. After last winter's supply crunch, much of the propane retail sector said "never again." Security has taken precedence over price and helped to initiate more sales and a higher level of fixed-price protection.

Exports. Nothing new here except that propane exports continue to grow, with May 2014 at nearly 14 MMbbl and natural gas still unable to export any waterborne product at this point. However, that will change shortly with ramped-up approvals of LNG export licenses. Another part of this variable is the fact that Targa Resources' planned Gulf Coast propane export facility expansion will be completed earlier than expected, and should add more capability in the latter half of this year.

Pipeline Infrastructure…or more accurately put, the lack of propane pipeline infrastructure. Place a map of all the natural gas pipelines next to a map of propane pipelines and you will understand. Natural gas appears to have pipelines running every which way all over the nation, while propane can boast a grouping of potentially three to four pipeline segments. Pipelines, the low-cost mode of transportation in the energy sector, abound in the natural gas segment but are sorely lacking for propane. Stacking up midstream asset investments, new propane pipeline projects are low on the priority list, evidenced by the Cochin reversal and the recently activated ATEX pipeline for ethane. The relative paucity of additional propane pipeline capacity and planned projects places a heavier reliance on other transportation methods.

Rapid production growth. This point may seem counter intuitive, but stick with me. Propane production reached nearly 1.6 MMbbld in mid-summer 2014 and has averaged nearly 1.5 MMbbld since the beginning of the second quarter. Average growth from 2013 is roughly 100,000 bbld, while the increase from second- and third-quarter 2013 alone stands at nearly 170,000 bbld. All of this production has to go somewhere, and growing inventory levels prove it is finding a home.

Supplier Failure. That's a touchy subject for many, especially after last winter, but it's a reality. The labyrinth of natural gas pipelines and large amount of storage facilities, all coupled with strong Federal Energy Regulatory Commission enforcement and contract language, indicate a more secure supply environment for the natural gas end user. But by no means does this imply a lack of price volatility—just talk to customers in New York, where prices hit $90/MMBtu last winter. It does imply that they may have more options, and the ability to secure a firm supply commitment at a higher price.

With limited pipeline capacity and nothing close to a firm contract available, the propane market has been reliant on the word and performance of the supplier for many years, and nine times out of 10 times that has worked. At the same time, over the past several years suppliers have merged, reducing the overall number of firms in the market. They have also migrated more risks to the downstream seller, and have set new priorities based on enhancing netback values. A strong economic incentive to export product has developed. These actions are driving more retailers and wholesalers to seek security within expanded storage in order to have more control.

Putting these five factors together—fear factor, exports, pipeline infrastructure, rapid production growth, and supplier failure—we can see clear evidence of the need for propane storage. For the past five years, Twin Feathers has been advising clients to increase their storage positions. Rising storage, however, does not necessarily mean that the market will be bullish or that product will not be available in the spot market. In fact, if production levels continue to steadily grow, spot gas may be a more viable option for the retailer this year and could create wide basis price swings—up or down—in certain market regions.

Strong storage levels, more production, and the prospect of spot gas does highlight a critical logistical issue for the propane retailer. One of Twin Feathers' mottos over the past three years has been "Hug your Trucker." Increased summer production is providing more business for truck transportation firms, and at the same time has created a more competitive search for available railcars. The winter of 2014-2015 may have one thing in common with last winter: retailers need to make sure they have secure transportation, specifically truck transportation.

Last winter's supply crunch underscored an age-old fact—railcars move slower during extreme cold weather. Cold weather, although probably not to the same extreme, will certainly return this winter and will slow rail traffic. Truck transports were routinely traveling anywhere from 500 to 1000 miles to deliver product last winter, in all temperatures and driving conditions. Going forward, strong storage volumes and slower rail will keep the focus on the trucking industry. Establish your relationship with one or more solid truck transport firms during the summer and use agreements to grab both product for your storage and any available spot gas.

Propane and natural gas definitely have similarities, but the differences are wide, particularly regarding pipeline infrastructure. The lack of pipeline transportation is driving more dependence on storage and truck and rail transportation for the propane retailer. Some areas of the nation may see more supply this coming winter, but some regions will still experience logistical and price challenges. As you enter this next winter we recommend the following: Plan for more storage solutions you control; be wary of over-contracting; and prepare during the summer in order to provide security and flexibility during the winter.

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