

Propane Resources Letter

Supply & Risk Management

A monthly resource of supply and distribution opinions for the propane industry.

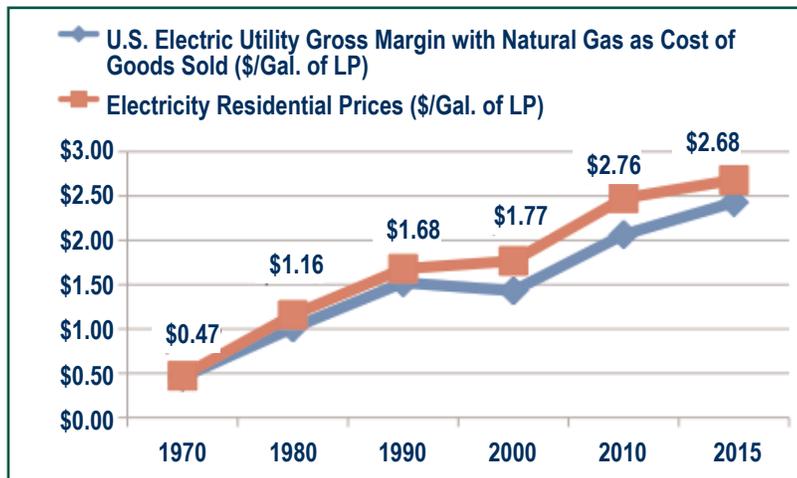
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Issue 283

DEAR PROPANE DECISION MAKER:

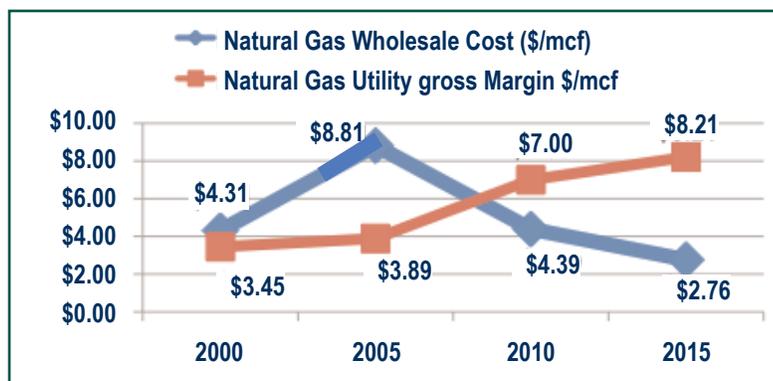
It looks like propane is entering a golden age. Over the years, electric and natural gas utilities have promoted their respective products and on a number of occasions propane has been the one that has taken the whippin'. It looks like it's time for propane to get some payback!

Looking at the top chart, we put everything into \$/gallon of propane so we could all understand. *The first thing noticeable is electricity prices never drop.* The decade of the 90's showed a fairly flat electric Residential Price that publicly traded electric utilities immediately corrected as we entered the 2000's. Since electric utilities' cost of making electricity is difficult to calculate going back to 1970, we used the price of natural gas, which is higher than coal, the main feedstock in making electricity.



Looking at the electric utility's gross margin in the top chart, you see it moves in *lock step with the residential electric price.* The price of natural gas or coal to make the electricity has little effect on the price the residential customer pays for electricity. *The biggest impact to the propane residential customer is the wholesale price of propane.* The propane industry is very different than electric and natural gas utilities.

The bottom chart looks at U.S. natural gas utilities since 2000. The wholesale price of natural gas peaked in 2005. Gross margins continued to rise 200 percent while natural gas wholesale prices plummeted 300 percent.



Why do residential electric and natural gas prices continue to move up? First, these utilities are monopolies in the areas they service. *Monopolies are usually very bad for the end user because there is no incentive to reduce costs.*

Second, electric and natural gas utilities are governed by some public utility commission. The utility has all rate increases approved and authorized through the Public Utility Commission. The goal for an electric or natural gas utility is to always ask for a rate hike that generates a higher rate of return for

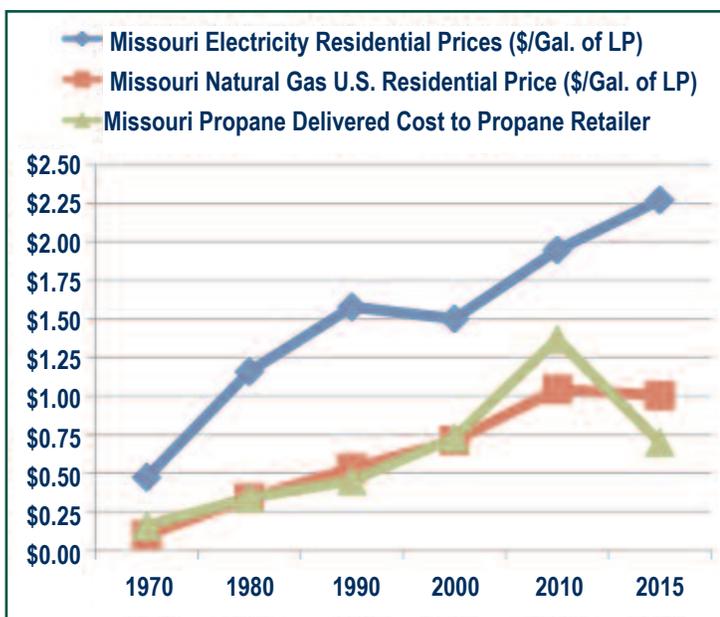
Propane Resources provides supply services to help retail propane marketers manage the price risk associated with market volatility and ensure physical supply availability. Helping retail propane marketers protect gross margins and build company value are primary goals.

Propane  Resources
Helping Business Partners Create Opportunity

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investors. *Third, electric and natural gas prices have more to do with infrastructure and legacy costs than underlying commodity prices.* For the most part, electricity is generated by coal or natural gas in the U.S. If consumer electricity pricing were based on underlying commodity, electricity prices would have dropped over the past few years. They didn't! The best and the brightest people in an electric/natural gas utility get moved into the area where they can figure out how the utility can spend money and the Public Utility Commission will allow it to be added into the BASE RATES! Why? Because each utility gets a percentage of the base rate as their income. It's about this simple, if the utility convinces the Public Utility Commission that they need to spend \$2 billion to take care of their customers' needs instead of \$1 billion, the utility makes twice as much money.

Electric/natural gas utilities have no incentive to lower prices to their customers. Utilities have been so successful at raising their prices that propane has become very competitive with electricity and, for the first time, can compete in some areas with natural gas!



We took the state of Missouri's electric and natural gas residential pricing and compared them to the delivered cost of propane for the average propane retailer. We chose Missouri because it is very representative of the states at large. In the top graph, we put residential electric prices in equivalent propane \$/gallon. You can see the homes in Missouri are now paying on average \$2.25 per gallon for their electricity and that will increase again next year. *Are there any propane retailers in the U.S. today that would not like to take that electric load for \$1.99 per gallon and save the home owner 26 cents per gallon (cpg)? If you owned a gas station and priced your gasoline 26 cpg less than all the other gas stations in town do you think you could sell more gas? Yet it is*

estimated that 4 million homes that heat with propane have electric hot water heaters! That opportunity represents one billion gallons of propane sales...enough to make the retail propane market 10% larger than it is today.

Notice where residential natural gas prices are currently and have been since 2010. They are equivalent to \$1.00 per gallon of propane. Natural gas prices have been flat for five years while their cost of natural gas has dropped the propane equivalent of 15 cpg. The natural gas utilities have been successful at adding additional expenses to their rate bases to hold their selling prices even as their product cost has dropped. These added expenses will not leave the rate base, so when natural gas prices finish bottoming out this next year and begin to increase, natural gas residential prices will increase as well.

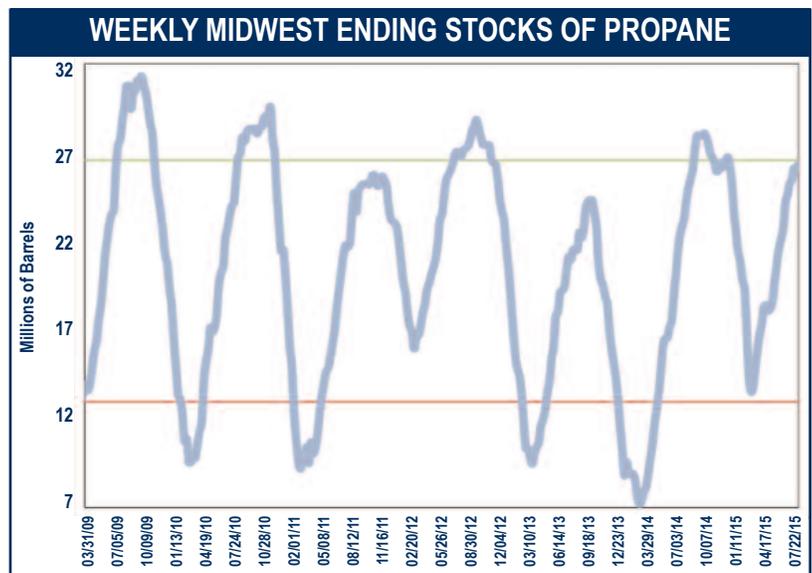
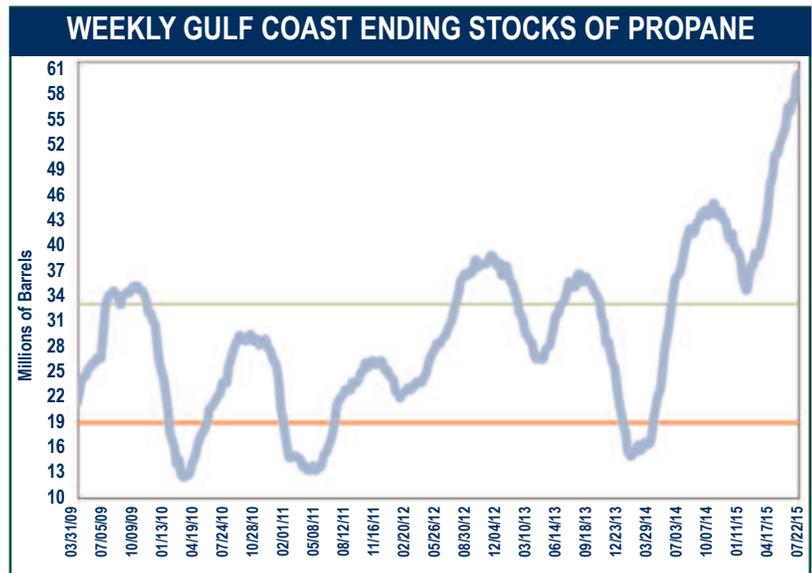
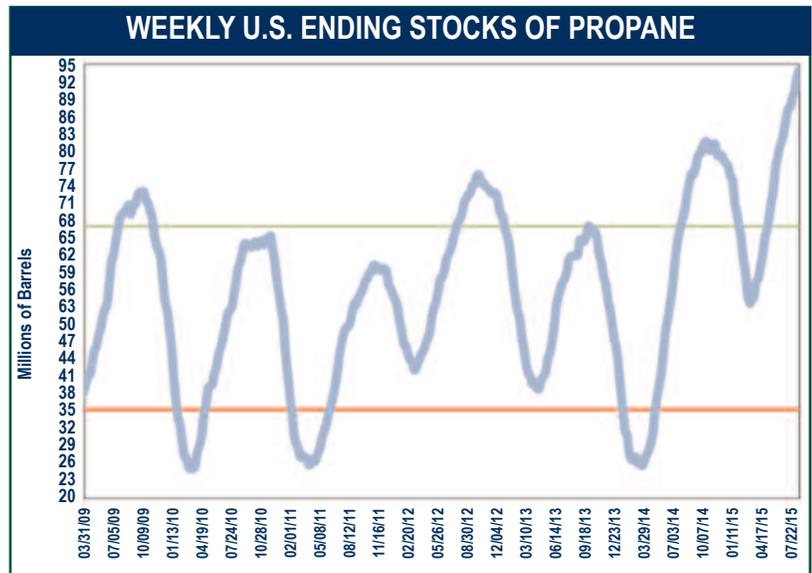
The added bonus for natural gas consumers is natural gas utilities asking for and getting approval to charge existing customers a higher rate so the utility can build additional capacity to prospective customers that currently use propane, therefore subsidizing growth through higher rates to existing consumers and making more money at the same time. *Do propane retailers get to do that?* This is one area our NPGA has helped the propane industry immensely through awareness to our elected officials. We are still behind the curve and probably always will be with our budget, but light years ahead of where we were 10 years ago!

TOTAL INVENTORY: Inventories continue to build and 100 million seems likely. Look for traders and exporters to be active in the market as we enter into fall and fourth quarter propane deliveries. Traders will target the post-Thanksgiving (Nov 26th) to Christmas timeframe as the window where the propane market could make a move. The question is, “Will it be up or down?” At this point it’s too early to tell. Added propane export capacity is now in a place that can drain Mt. Belvieu, but will the world market be able to absorb it?

GULF COAST INVENTORY: Mt. Belvieu has the highest level of propane inventory on record. Mt. Belvieu traders are going to need to figure out how to move propane as we enter into the 4th quarter. Teppco will only move a fraction of the propane they have historically moved north due to Enterprise’s restrictive nomination policy and the reversal of one of their pipelines. This leaves exports as the alternative. All this export infrastructure better start getting used or there is going to be alot of downward price pressure on propane.

MIDWEST INVENTORY: Conway propane prices continue to edge closer to Mt. Belvieu prices as it looks like a floor is forming at Conway. MAPCO pipeline maintenance could have an impact on the inventory report over the next few weeks as some east leg terminals were shut down for an extended period of time. Look for Conway prices to make a push up to or exceed Mt. Belvieu prices as traders will see more volatility opportunity with Conway.

Conway inventory can dissapate fast!



Bulls

1. Producers may be forced to shut in production and sell off assets as banks stop giving them money.
2. Crop drying is beginning to look real now.
3. The propane pipeline infrastructure is still transitioning causing price blow outs.
4. The “Market Vane Consensus” shows that most everyone is a bear looking for lower prices, that is when the market usually turns the other way.

Bears

1. World stock markets keep crashing, pulling down crude and energy prices.
2. World propane prices keep edging down putting pressure on U.S. export prices.
3. Propane inventory will take a push at 100 million barrels this year.
4. Propane producers have no place to go and must continue producing ethane and propane at any price.

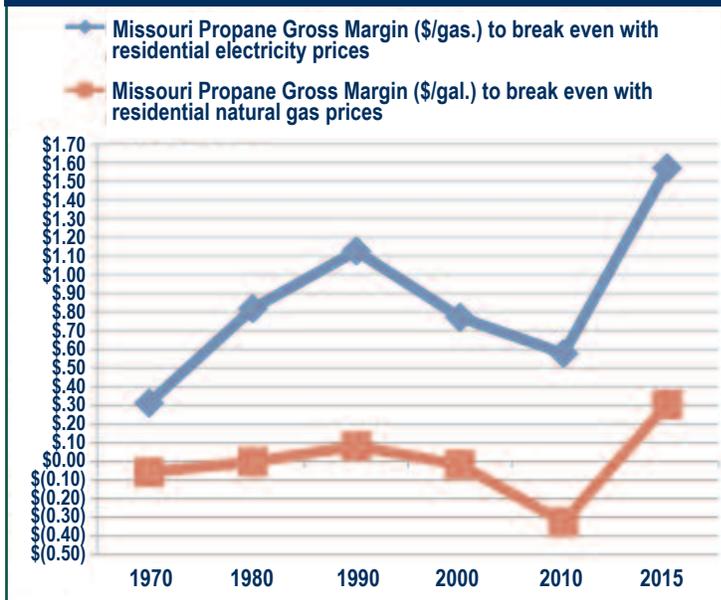
SWAG: At right, there’s a Missouri retailer with a gross margin of \$1.60 per gallon on a break even basis vs residential electricity prices. The opportunity for the retailer is to explain to the home owner how propane can save them 60 cpg to heat water or cook food and still make \$1.00 per gallon gross margin.

Propane retailers across the U.S. must compete in a free market. This market requires excellent service at a reasonable price to the consumer. Ever notice how responsive you are to your customers’ needs, yet the regulated services you use (like electricity or government office) are not as responsive? There’s no need to be responsive if you have a captive customer. Propane retailers have no captive customers. This is what makes you as good as you are!

This sets the stage for the propane industry to enter a golden period. Propane retailers look for ways to cut costs to stay competitive and make more money. Regulated utilities live in a world where they look for ways to add costs to make more money. The tables have now turned to the point where propane is the more cost effective product to begin to displace electricity demands for certain products and that market it huge.

ACTION PLAN: Propane prices are low on the forward price curve through next year. Take advantage of these lower prices, buy them and market them to your customers and prospects!

HEADER



We're always glad to hear from you!



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