Review of Regulated Fuel Margins, Costs and Full Service Charges in New Brunswick

Addendum re propane

submitted to:

New Brunswick Energy and Utilities Board

submitted by:

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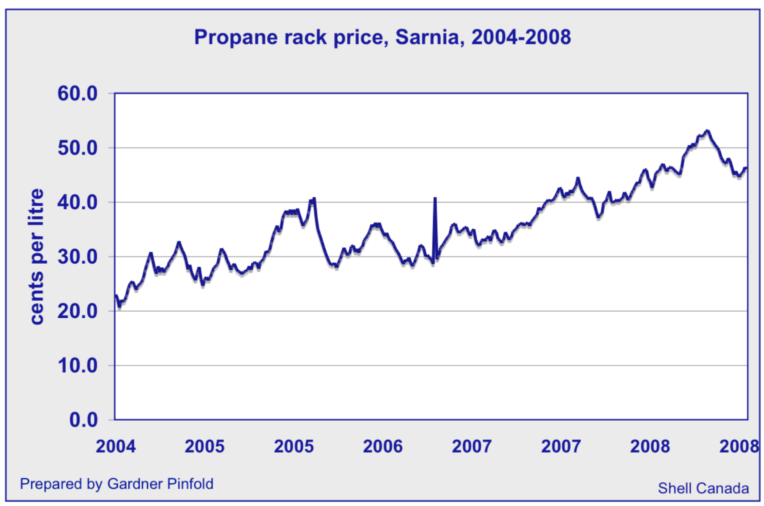
1. Supply, demand and prices

Propane is among the heating fuels regulated under the *Act*. It accounts for a relatively small share of the heating market, with industry representatives estimating its contribution in New Brunswick at less than 1%. Propane's main applications are cooking and supplementary space heat and in these uses it competes with several fuels, including natural gas in recent years.

Over 80% of propane supply in Atlantic Canada is imported from Sarnia, Ontario. Propane is extracted from natural gas in western Canada and shipped by pipeline to Sarnia, where it is transshipped by train to terminals in eastern Canada, including ones in New Brunswick. Propane may also be trucked into the province from Statia Terminals in Nova Scotia, where it is stored following extraction from Sable natural gas. Propane may also be produced from crude oil refining, though quantities produced are small in Canada and account for a relatively small share of supply in the Atlantic Provinces.

The price of propane is closely linked to the price of natural gas and to crude oil, in part because it is derived from these commodities, but also because it competes directly with natural gas and fuel oils in primary markets such as the U.S. northeast. This connection means propane prices fluctuate seasonally with weather conditions, and can swing widely in response to events affecting those commodities. The benchmark price in eastern Canada is the rack price (quoted by Shell and BP Canada) at the Sarnia terminal. Fig. 1 shows how the propane rack price has developed since 2000.

Fig. 1: The Sarnia rack price for propane tends to follow crude oil prices. This is because propane is a substitute for such petroleum products as heating oil.



2. Marketing margin

From rail terminals in Moncton, Saint John and Edmunston, propane is trucked to retailers' bulk plants in major markets in the province. From there it is distributed to residential and commercial customers. The regulated margin to cover all costs from Sarnia to customer is 60.0 cpl. This is substantially higher than the margins for motor fuels and heating oil because the cost of service is much higher due to market characteristics (limited number of customers spread over wide area, with each taking relatively small deliveries), and because of higher equipment costs and the need to meet more stringent safety requirements.

The 60 cpl marketing margin is notionally divided into three components:

- 25 cpl to cover wholesale costs (transportation and storage)
- 25 cpl to cover retail costs (transportation and storage)
- 10 cpl to cover delivery (from bulk plant to customer)

Data on retail market prices is not available from published sources, so it is impossible to provide any perspective on how the regulated marketing margin compares with historic values. Anecdotal information from some industry representatives suggests that the regulated margin was initially set below the historic margin. Attempts to verify this had not been successful at the time of writing. Consequently, it is impossible to say on the basis of an analysis of historic gross margins whether the initial setting for propane was "justified" or not.

The six companies supplying propane in New Brunswick operate almost exclusively at the retail end of the business. They ship product in from Sarnia, store it in their bulk plants and deliver to customers. Two operate on a province-wide basis and four in regional markets.

The business is essentially about transportation and storage, and as such has faced cost escalation factors comparable to those affecting motor and heating fuel transportation (delivery from refinery and bulk plant to retail outlets in the case of motor fuels, and delivery from refinery to bulk plant and from bulk plant to customer in the case of heating oil). Other operating costs have also increased at comparable rates (labour is included in other operating costs in the propane analysis, given the capital intensiveness of the industry).

3. Adjusting for rising costs

Given the rising costs, there would appear to be justification for an adjustment to the marketing margin and delivery allowance. The total adjustment is estimated at 5.30 cpl (rounded). Details are set out in the following tables.

Transportation: Sarnia to New Brunswick

	Marketing margin	Sarnia to Moncton delivery cost (1)	Increase in freight cost (2)	Impact on gross margin
	cpl	share of margin		cpl
2008 vs 2006	50	18%	15%	1.35

Source:
1. Propane dealers (subject to verification)
2. Based on fuel transportation industry fuel adjustment charge formula applied to difference in diesel prices, July 2006 vs. July 2008

Other costs

	Marketing margin	Share of total operating costs (1)	Increase in operating costs (2)	Impact on gross margin
	cpl			cpl
2008 vs. 2006	50	82%	6%	2.46

Source:
1. Total operating costs less delivery cost to terminal
2. Statistics Canada, Implicit chain price indexes, gross domestic product, 2006-08.

Delivery allowance

	Delivery allowance	Increase in operating costs (1)	Impact on gross margin
	cpl		cpl
2008 vs. 2006	10	15%	1.50

1. Based on fuel transportation industry fuel adjustment charge formula applied to difference in diesel prices, July 2006 vs. July 2008