Petroleum Products Pricing Commission

Review

Petroleum Products Pricing Regulations
In
Newfoundland and Labrador

Submitted to

Honourable George Sweeney, Minister
Department of Government Services and Lands
Government of Newfoundland and Labrador

March 12, 2003

Prepared By:
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Commissioner

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Hon. George Sweeney, Minister
Department of Government Services and Lands
Government of Newfoundland and Labrador
P. O. Box 8600
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Hon. Mr. Sweeney;

I am pleased to submit the report of the "Review" for the Petroleum Products Pricing Commission, which was undertaken by this office during the period of January 8, 2003 to March 7, 2003.

We respectfully request you give due consideration to the recommendations pertaining to amendments of the Act and Regulations, and await your response.

May I take this opportunity to thank you personally and your staff, especially Deputy Minister Wakeham and Assistant Deputy Minister Morris, for their assistance and cooperation provided during the course of the review process.

Respectfully,

Petroleum Products Pricing Commission

George Saunders
Commissioner

Encl.

GS/kp

Background

The Petroleum Products Act, Chapter P-10.1, came into effect on May 24, 2001. With the establishment of this law, the pricing of petroleum products in the province of Newfoundland and Labrador was placed under the control of the Office of the Petroleum Products Pricing Commission (PPPC).

The Petroleum Products Act establishes the legitimacy of the Commission. It empowers the Commissioner by providing necessary authority to administer the Act. It also defines the responsibilities of the Commissioner necessary to carry out regulation.

Since October 2001, the PPPC has established monthly maximum wholesale and retail base prices for motor fuels using a model based on the tracking of Platts New York Harbour benchmark prices. During this period, there have been two or three occasions when significant and sustained increases or decreases in the benchmark prices could have warranted interim adjustments in the base prices for gasolines and distillate fuels. The Commissioner, however, only made one interim adjustment, dated January 3, 2003.

During the past year, prices overall in the petroleum industry have sustained increases, and on several occasions these increases have been subject to spiking throughout North America. These dramatic increases in world oil prices are due primarily to the anxieties and uncertainties surrounding the threat of war in the Middle East coupled with the massive general strike in Venezuela, which has paralyzed petroleum production in that country.

Since the Commission adjusts prices on a once a month basis by averaging changes in benchmark prices during the previous 30-day period, the Newfoundland and Labrador consumer has been insulated from the fluctuating prices, which have occurred in unregulated markets on a frequent basis, especially in the past 90 days.

While the consumer has a measure of protection, companies and resellers in the marketplace who supply petroleum products to consumers have sustained reduced revenues in our province and this reduction has produced circumstances with the potential of impacting on the security of supply in the province, as well as on the ability of resellers to sustain their operations in the marketplace.

Therefore, in a regulated environment, the Commission's mandate has to be implemented in an atmosphere that is transparent and fair to all stakeholders, and consider the requirements to achieve stability in both normalized markets as well as extremely volatile markets.

Introduction

Since the PPPC began regulating prices on October 15, 2001, it has faced many challenges. From the establishment of the Commission to the most recent regulation period, there have been a myriad of emerging issues that have required caution and due diligence to ensure the PPPC appropriately fulfills its mandate of price regulations in a fair, transparent, and stable manner.

The action of January 3, 2003, which saw an interruption in the regular model, and the subsequent market behaviour since that time have contributed profoundly to the necessity of this review. These actions and developments in markets in Newfoundland and Labrador, and issues evolving from them have called into question the effectiveness of the PPPC administration when regulating petroleum products prices.

Petroleum products are commodities that are traded daily on commodities exchanges throughout the world. Thus price fluctuations have the capacity to change daily, especially in volatile periods influenced by emerging world events. Companies therefore argue that these commodities cannot be regulated effectively and efficiently. However, the experience of the PPPC leads us to conclude that regulation can work with processes that respond to volatile periods as well as normal market behaviours. The challenge is to establish regulatory processes that are fully understood by the population at large, as well as the industry players.

The legislation and regulations governing the operation of the PPPC are relatively new, and essentially very effective in defining the processes to be used in regulating prices under normal market conditions. It also provides emergency powers to the Commissioner to use when necessary.

However, the Commission can be subject to pressures and influences to act based on a judgment call rather than on any definitive set of contributing variables.

This internal review will therefore address issues and concerns with respect to the legislation as well as the model used for pricing regulation.

Overall, this exercise has provided us the opportunity to assess existing procedures and practices, as well as determine methods and potential improvements aimed at providing a strong and healthy process for the Commission to meet the needs and interests of all stakeholders.

The Review

In accepting the challenge of conducting the review, it was agreed to consult with all stakeholders to the process: government, industry stakeholders – suppliers (companies), resellers, retailers, and consumer groups. During the past 60 days, every group was given an opportunity to be heard and to present their concerns to the Commission.

As a result of these meetings, there has emerged a body of concerns that require action and address:

A) Timing of price increases/decreases;
B) Base price review for motor fuels/distillate fuels (furnace oil, stove oil, and diesel);
C) Zonal boundary consideration; and
D) Legislation and regulations.

The remainder of the report lays out the rationale together with the proposed actions at the Commission level and recommendations respecting changes required at the government level. The actions detailed in the report will come into effect with regulations of pricing on March 15, 2003.

Timing of Price Increases/Decreases

As was noted earlier in the report, there have been a number of occasions since regulation began when significant and sustained increases or decreases in the benchmark New York Harbour prices could have warranted interim adjustments in base prices for gasolines and distillate fuels.

The Commission's actions of non-intervention has caused concerns at both the supplier (company) and the reseller levels.

On January 3, 2003, the issue of security of supply was evident at the time, and the Commissioner intervened to adjust prices outside the normal model.

Since January 3, 2003, there have been sustained increases for distillate fuels, but no intervention has been taken because of the ongoing review process. It is also important to point out that in the absence of a clear set of criteria governing a basis for intervention, the decision to take such an action is left solely with the Commission, which is subject to individual pressures from suppliers and resellers or both, while the end user or consumer has little or no knowledge of the need for pricing adjustments.

Industry pricing adjustments for these products are made on a daily basis, usually consistent with changes in the benchmark prices the previous business day, while base prices set by the Commissioner are set using the averaged change over the previous 30 days and remain fixed for the following 30 days. Thus when benchmark prices move up or down rapidly and steadily in one direction over a period of a week or more, the difference between industry prices and PPPC base prices cause one of the following problems:

1. As benchmark prices rise steeply, the oil distributors or resellers who buy at benchmark prices sustain a reduced margin and in cases have been forced to buy at a benchmark price that is above their maximum selling price set by the Commissioner.

2. As benchmark prices fall steeply, the consumer must wait until the next monthly cycle before retail prices are adjusted downwards, while at the same time oil companies and resellers reap a much larger margin than was intended.

The problem is therefore one of the timing of price changes.

Following a review of the PPPC's pricing model and input of stakeholders through meetings with consumer groups, resellers, oil companies and others during the past six weeks, the Commission has developed the following procedure which, in as fair a manner as possible, should ameliorate the timing problem.

a) If the benchmark price of <u>**regular unleaded gasoline**</u> moves up or down and the resulting movement is sustained at an average of 3.5 cents per litre or more for five consecutive business days, the Commission will make a price adjustment to all gasoline prices based on the average difference back to the time of the previous adjustment.
b) If the benchmark price of <u>**diesel fuel**</u> moves up or down and the resulting movement is sustained at an average of 3.5 cents per litre or more for five consecutive business days, the Commission will make a price adjustment to diesel fuel prices based on the average difference from the previous adjustment.
c) If the benchmark price of <u>**No. 2 heating fuel (furnace oil)**</u> moves up or down and the resulting movement is sustained at an average of 3.5 cents per litre or more for five consecutive business days, the Commission will make a price adjustment to furnace oil and stove oil prices based on the average difference from the time they were previously adjusted.
d) Propane figures originate from a different source than all other regulated fuels; therefore, there needs to be a higher interruption price added to propane. If the benchmark price of <u>**propane**</u> moves up or down and the resulting movement is sustained at an average of 5.0 cents per litre or more as is currently averaged each week using Bloomberg OBG, the Commission will make a price adjustment to all propane prices based on the average difference back to the time of the previous adjustment.

The normal monthly adjustment will still be made based on average changes in the applicable benchmark prices since the last adjustment. Interim adjustments in the four product groups will be made as necessary independent of each other.

Rationale for the "Interruption Formula"

The interruption formula described above would be advantageous to all stakeholders.

The margin per litre on the sale of gasoline at the wholesale level is quite limited and includes all expenses to be borne by the company and reseller in the market.

Therefore, if the benchmark price increases 3.5 cpl or more and remains at that level for more than a few days, the reseller who is otherwise limited by the maximum wholesale price he can charge the retailer by the PPPC, will start to lose money on each delivery.

The Commissioner conducted a study on the tables of regulated prices from October 15, 2001, to February 15, 2003, to evaluate how many price adjustments, other than normal mid-month adjustments, would have been necessary to restore the margin to a neutral position for the reseller in the marketplace as well as correct any excess margin accruable because of falling prices, which would benefit the consumer, based on a 3.5 cents per litre fluctuation.

This study identified four cases where an interim price adjustment could have been necessary if the formula had been developed. These have been identified and two of them described here in detail.

The 3.5 cpl limit is therefore considered appropriate to engage the adjustment mechanism.

A similar exercise was employed for furnace oil and again the 3.5 cpl differential was considered reasonable. In this case these potential adjustments were identified during the 16 months of regulation.

Price regulation became effective October 15, 2001.

1. During the five day period October 29 to November 2, 2001, just after the gasoline price regulation became effective, New York Harbour prices for RUL (Regular Unleaded Gasoline) fell an average of 4.4 cpl below the benchmark price used to set price regulation on October 15. This would have triggered a decrease in the base price and therefore the maximum wholesale and retail price set by the Commission of 4.2 cpl before tax on November 5. As it was, the price was reduced by 4.4 cpl on November 15, 2001. Under the proposed model consumers could have paid 4.8 cpl less at the pumps for the ensuing 10 days.

2. The second case occurred in mid March 2002 when prices jumped an average of 5.8 cpl over five days from March 12 to March 18, 2002. At that time, the PPPC did not introduce any relief to the market and during the period mid-March to mid-April wholesale margins disappeared altogether with total margin on April 2 being only 3.2 cpl versus the normal 12.0 cpl. This was a time of great stress for the companies and resellers who put great pressure on the Commission to move prices upwards. No interim adjustment was made.

As a result, a 7.4 cpl increase in prices was instituted as the normal mid-month adjustment on April 15, 2002.

Had the proposed mechanism been in place a 6.7 cpl increase would have been introduced on March 21 and only a 0.9 cpl adjustment on April 15. This would have cost consumers more for the period. However, the companies and resellers lost a considerable amount of money during this period due to an unresponsive regulatory system.

Two other instances occurred, which would have engaged the adjustment mechanism, one in November 2002 with a price decrease of 4.8 cpl for over two weeks and the other, an increase of 5.3 cpl in late December 2002 which would have alleviated the need for the 5.8 cpl emergency interim increase instituted by the PPPC on January 3, 2003.

Had this methodology been employed during the period the Commission started regulating prices based on its existing model (October 15, 2001) to date, there would have been several interim changes in gasoline, heating oil, and propane prices.

The change in methodology to incorporate the above adjustment into the Commission's pricing model will become effective as of March 15, 2003.

By employing this interruption formula, we are establishing a criteria that provides a greater overall fairness and transparency to pricing. As well, it maintains a functional level of stability, especially in periods of volatility related to world events that impact on petroleum markets. When circumstances warrant, the Commissioner still has the right under legislation to intervene at any time.

Adjustments to the Base Prices of Gasoline

The base price of gasolines was established based on the average difference between the New York Harbour benchmark price for regular unleaded gasoline (RUL) and that of the ex-tax price of RUL at self-serve retail pumps in St. John's. The difference in these prices was averaged daily over a 2½ year period (April 1, 1999 to September 20, 2001), and converted to Canadian cents per litre using the Bank of Canada daily noon currency exchange rate. This overall difference was calculated to be 11.69 cents per litre (cpl), which was rounded up to the adopted 12 cpl differential.

After consultation with stakeholders, as well as further research conducted by the staff of the Commission, it has been concluded that an increase in the base price of gasoline is warranted due to higher costs resulting from changing population patterns, more stringent environmental regulations, rising insurance costs, and increasing capital and operating costs associated with marketing gasoline throughout the province. Accordingly, and notwithstanding strong arguments for a larger increase, an adjustment of 1.5 cents per litre is being made to the base price of gasolines at this time.

There will be no adjustment in zone differentials as a result of the review. However, the Commission recognizes the need for a comprehensive study of land transportation and distribution costs within the province. Such a study would identify more realistic cost factors, and thus provide more accuracy in zone differentials throughout the province.

Adjustments to the Base Price of Furnace Oil

The base price of furnace oil was established based on the year-round historical difference between the benchmark New York Harbour price for No. 2 fuel oil and the price charged for furnace oil delivered to home owners in St. John's. It has been brought to the Commission's attention that suppliers often have to blend in a percentage of lighter fuel, such as stove oil or jet fuel, to ensure furnace oil is suitable for storage and use in the coldest temperatures experienced throughout the Island portion of the province. As a result, the PPPC will now calculate furnace oil prices using a price composed of 75% jet price and 25% No. 2 distillate price to arrive at a price in line with existing market costs.

Retailer Margins

Discussions with retailers of gasoline during the review process were limited. We are aware of the move in the province to establish a Retailers Association and see this as a positive venture overall. With its establishment there would then be a link with all stakeholders respecting the petroleum industry here.

At the time regulation began, retailers in the province were provided with healthy margins for both full-serve and self-serve brands of all gasolines. These margins will remain in effect as is, with no changes. They are considered to be fair for the industry. It is acknowledged, however, that some stakeholders questioned the relatively high level of retailer margins during the review process. However, the Commission believes the established levels are necessary for these dealers to operate successfully in the business.

Zonal Boundaries

During the review consultation, there was very little concern expressed about the structure of pricing zones in the province. Fundamentally, our geography is structured so that transportation and distribution are real costs over and above the base price of petroleum products. As such, geographic differences are required making the zones significant.

Since regulation began, there have been changes made to some zone boundaries, as well as some sub-zones, to reflect costs specific to these areas. The Commission reserves the right to continue to accept representation for consideration of zonal boundary changes based on valid evidence to support such changes.

Last year, there was an adjustment made to Zones 6 – Deer Lake/Corner Brook/Bay of Islands/Grose Morne and Zone 8 – Northern Peninsula – Lobster Cove/Gros Morne National Park to Bellburns boundaries following an investigation undertaken by Commission staff. Following these changes, further representation was received from the area objecting to the movement of the boundary. Their argument was a change had the potential of impacting on the cost of distribution along that portion of the Northern Peninsula.

During the review, it was further revealed that the changes had little effect on the overall market in Zone 8. In fact, delivery costs versus the retail prices of product was the only change noted for this region.

Therefore, the boundaries of zones 6 and 8 will revert to the position they were in prior to September 15, 2002. For information and clarification the zonal descriptions are printed below and included in this report.

Zone 6 – Deer Lake/Corner Brook/Bay of Islands – All points along the Trans-Canada Highway, from Sandy Lake west to the intersection with Gallants, including Howley, Deer Lake and Route 430 to Wiltondale, to Gros Morne National Park boundry. All the city of Corner Brook – Bay of Islands region, through to Lark Harbour and Cox's Cove, and all communities and service areas in the region.

Zone 8 – Northern Peninsula/Gros Morne National Park to Bellburns – Route 430 from Wiltondale north to Batteau Cove, including all communities within Gros Morne National Park to Norris Point, and then along the coast north to Bellburns.

Legislation and Regulations

The pricing control model adopted and used by the PPPC during the past 16 months has served consumers well in stabilizing retail prices throughout the province. During the past two months, however, there has been a dramatic increase in world oil prices due to the anxieties and uncertainties surrounding the threat of war in the Middle East coupled with the massive general strike in Venezuela, which has paralyzed petroleum production in that country. As a result, gasoline and home heating fuel prices have spiked up throughout North America.

Since the Commission adjusts prices on a once per month basis by averaging changes in benchmark prices during the previous 30-day period, the Newfoundland and Labrador consumer has been insulated from the fluctuations in prices, which have occurred in unregulated markets on frequent basis during the past 90 days.

The Problem

The major oil suppliers in the province who provide products to local resellers adjust product rack prices to these independents on a daily basis in most cases and on at least a weekly basis for others. Adjustments to rack prices are based directly on the change in the benchmark New York mercantile exchange prices for the previous business day. When benchmark prices are rising, as we have experienced during past several months, the rack prices to the resellers therefore rise in tandem, which means that with the maximum selling prices fixed for the month by the PPPC, the reseller margins shrink. In early January, the gross operating margin for resellers for retail gasoline was in fact negative, causing them to either lose money on each delivery or to cut off supply to their retail dealer accounts. The Commission acted to help correct this crisis situation by instituting an interim price adjustment on January 3, 2003, instead of waiting to make its regular adjustments on January 15, 2003.

To avoid this margin squeeze suffered by local resellers during periods of increasing prices, both the resellers and the Commission have made requests and overtures to the major rack suppliers to apply price adjustments on a monthly basis concurrent with the adjustments made by the Commission. Notwithstanding the fact that in the long term the financial impact on them in making this change would be essentially neutral, they have resisted even the suggestion of less frequent price changes to resellers.

It should be noted that when prices decrease, the resellers should gain back much of the lost margin they have sustained during the period of increases. This however, matters little since most do not have the financial resources to provide the cash flow to see them through the periods when margins are squeezed. Moreover, the industry has seen consistent increases in pricing during the past year, with very few decreases, a circumstance that has placed resellers in difficult financial positions on several occasions.

During the past 15 years, and more predominantly during the past five years, the major gasoline marketers in the province have been undertaking a rationalization of their retail networks. They are rapidly withdrawing from rural markets and concentrating on larger volume outlets in growing urban centres. The small 'Mom and Pop' retail outlets in rural Newfoundland have been unbranded and left to seek supply from whomever they can. The local resellers are filling this void to the extent they have the resources to do so. They have limited profit margins in the best of times and the cost to truck small amounts of product to distant rural outlets is quite high on a cents per litre basis.

This change in the marketplace of the province, whereby major companies are withdrawing and the rural markets are served by resellers, has increased dramatically in the past two years, and is expected to continue.

It must be emphasized that this rationalization is not unique to this province. It was confirmed through the consultations that similar changes are occurring across the country in small rural areas in particular.

When the Act was designed, it was based on several recurring themes and principles. In this province, regulation was to be restrictive in nature with minimal intrusion into the marketplace. It was also assumed that the market was structured along traditional business structures, ie: a wholesaler provides product to a retailer who in turn provides product to a consumer for a price. The Act did not foresee or anticipate the growth of the reseller in the marketplace, and hence the reseller is not defined at present.

After extensive research into this aspect of the petroleum industry in Newfoundland and Labrador, it is clear that these resellers are an integral part of the business here. Moreover, they are not merely restricted to rural Newfoundland, for they also are very much involved in business in the major urban areas of St. John's, particularly in the retail home heating business.

If regulation is to be effective in this province, then the reseller needs to be incorporated into the legislation. This will require amendments to the Act and its governing regulations.

During the consultations with government as part of the review process, the situation and circumstances of resellers in the marketplace was discussed at length. There is general agreement between the Commission and government that recommendations be made to the Minister to conduct a study of the legislation and incorporate all necessary changes. Supplying companies and resellers are invited to express their concerns to the Commissioner regarding any issues they may have with respect to the legislation.

Assessment Regulations

Section 23 (e) states:

> The Lieutenant Governor in Council may make regulations
> (e) requiring wholesalers and retailers to whom this Act applies to pay the costs of the office of the Commission and the costs associated with the holding of a hearing and prescribing the manner of calculating and apportioning those costs.

The first Petroleum Products Assessment Regulations became effective December 18, 2001, and were applied in 2002-03 fiscal year. While these regulations were applied exclusively at the wholesale level, there were questions raised by petroleum companies about which products constituted wholesale transactions according to the Act.

Since there was significant debate concerning the application of this regulation, it was agreed during the review process to revise this regulation to make it more explicit in its application, and therefore more efficiently administered.

We are pleased that the revised Regulation on Assessment is now approved and in effect.

Conclusion

The Review of the Petroleum Products Pricing Regulations has produced an action plan to assist the Commission in meeting the challenges at all levels of operations in the downstream industry in the province.

With the assistance of the province in moving forward with recommended amendments to the legislation, all stakeholders to regulation will have a measure of protection within the system, including resellers in the market.

The adoption of an interruption formula will provide an automatic measure to assist consumers, resellers, and companies during peak periods of high volatility in the marketplace, based on world conditions. The shock effect that accompanied the January 3, 2003 interruption will be eliminated, and pricing in the province will be more realistic without any stakeholders at a disadvantage because of regulation.

The adjustments to base prices of gasoline will insure secure markets in the province, with fair prices to consumers and fair return to the businesses involved in the industry.

When the Commission was established, its mandate was to provide fair, transparent, and stable pricing of petroleum products in our province, and to ensure that price would not be a factor affecting security of supply. As well, there was to be minimal intrusion into the marketplace, and to proceed with an atmosphere of cooperation with the industry. We have always been able to maintain open channels of communication with the petroleum companies and resellers. It is our hope that this line of communication will continue far into the future.

Actions to be Taken

Effective March 15, 2003

Interruption Formula will take effect

If the benchmark price of regular unleaded gasoline, diesel fuel, and/or heating oil moves up or down and the resulting movement is sustained at an average of 3.5 cents per litre or more for five consecutive business days, the Commission will make an adjustment to prices based on the average difference from the time they were previously adjusted.

If the benchmark price of residential propane moves up or down and the resulting movement is sustained at five cents per litre or more, as is currently averaged each week using Bloomberg OBG, the Commission will make an adjustment to prices based on the average difference from the time they were previously adjusted.

These interim adjustments in the four product groups will be made as necessary independent of each other.

Base Price Adjustments

The base price of gasoline in the province will be increased by 1.5 cents per litre over New York Harbour benchmark pricing with March 15 adjustments. This increase is in addition to any change brought forward as a result of average pricing over the past 30 days. This will take into account, in addition to historical data, consideration of demographics, new environmental regulations, rising insurance costs, and increasing capital and operating costs associated with doing business.

Furnace oil pricing will reflect any additional costs incurred as a result of blending of jet fuel to ensure the product's suitably for storage and use during the cold winter season.

In the provincial zones where fuel prices are currently frozen, these adjustments will take effect when price changes resume.

Zonal Changes

The Commission will receive applications for zonal changes when solid evidence is provided to support any changes. The only zone change to occur as a result of the review is that Zone 6 and Zone 8 will return to its original boundaries to reflect true pricing in the marketplace and restore true costs associated with distribution.

Legislation and Regulations

The Commission is recommending to the Minister of Government Services and Lands that amendments be made to the Petroleum Products Act to include resellers in the Act and Regulations. As well, we are asking for a study of the Act overall to ensure that all provisions of the legislation address the concerns and issues associated with the changing marketplace of the province because of demographics and rationalization of the industry.