

## 2.0 Background

### 2.1 The Petroleum Products Act

In 2001, the Government of Newfoundland and Labrador responded to consumer concerns with respect to prices charged for automotive and home heating fuels through the introduction of the Petroleum Products Act and accompanying Regulations.

*The Act was proclaimed into law on May 24, 2001 with the primary objectives of establishing a process that would enable:*

- *Pricing stability.*
- *Predictability of price changes.*
- *Transparency as to how maximum prices are determined and changed.*

Copies of the Act and Regulations are available through the provincial government website or from the Office of the Queen's Printer.

To administer the Act, a Petroleum Products Pricing Commission office directed by a Petroleum Products Pricing Commissioner was established in Grand Falls - Windsor.

In the spring of 2004, during the 45<sup>th</sup> General Session of the House of Assembly of Newfoundland and Labrador, *AN ACT TO AMEND THE PETROLEUM PRODUCTS ACT* was introduced, passed and became law on June 8, 2004. One of the amendments to the Act was to remove reference to the Commissioner and transfer the authority, duties and functions of the Commissioner to the 'Board' where the 'Board' means the Board of Commissioners of Public Utilities established under the *Public Utilities Act* of Newfoundland and Labrador. The Petroleum Products Pricing Commission office in Grand Falls – Windsor became the 'Petroleum Pricing Office' of the Public Utilities Board.

*Because this Study was commissioned prior to the above amendment to the Act, and for the sake of clarity, where the **Petroleum Products Pricing Commissioner** is referenced in this Report, it should be taken to mean the **Board of Commissioners of Public Utilities**, and where the **Petroleum Products Pricing Commission (PPPC)** is referenced it will mean the **Petroleum Pricing Office (PPO) of the Public Utilities Board of Newfoundland and Labrador (PUB)**.*

### 2.2 Petroleum Products Pricing Commission and Price Regulation

Under the Act, the Commissioner is empowered to set, and shall set, maximum wholesale and retail prices for automotive and home heating fuels sold directly to the consuming public throughout the province. The Commissioner also has the authority to determine the minimum and maximum mark-up between the wholesale prices and retail prices to consumers for these regulated products.

The consultant's understanding of the overall objective of the PPPC is to enable consumers to purchase petroleum products at fair and reasonable prices while at the same time help foster a competitive marketplace and, to the extent possible, ensure security of supply. Price regulation of consumer products is a complex matter and needs to be implemented and administered in an informed manner. The regulatory process must recognize the delicate balance between fairness in consumer pricing and reasonable financial returns to major oil companies and to local product supply chain participants.

## **2.3 Establishment of Base Prices**

In order to set maximum wholesale and retail prices, it was first necessary to set 'base prices' for each product. The establishment of initial base prices for each regulated petroleum product required the identification and selection of industry recognized 'benchmark' prices to which base prices could be referenced. Benchmark prices are regularly posted market prices recognized by all stakeholders and readily available as standard reference prices. Once chosen, benchmark prices first provide a basis to establish initial base prices, and then provide a reference for an adjustment mechanism by which subsequent changes in base prices can be made on a periodic basis. For gasolines, diesel fuel, and furnace oil, the benchmark prices chosen were the industry recognized New York Harbour Cargo Prices as published at the close of each business day by Platts – Oilgram Report (Platts). For propane, the benchmark price chosen was the average weekly contract price at Sarnia, Ontario as published by Bloomberg Oil Buyer's Guide (OBG).

The initial base price for regular unleaded gasoline was established by comparing the average differential between New York Harbour Cargo prices to that of the ex-tax price of self-serve regular unleaded gasoline in St. John's, Newfoundland tracked daily over a two and one-half year period from April 1999 to September 2001. The average daily Platts prices, which are quoted in US Cents per US Gallon, were converted to Canadian Dollar Cents per Litre (CPL) using the noon Bank of Canada exchange rate for each business day.

This gave an average differential which, when added to the posted Platts price, gave an ex-tax self serve retail pump price for regular unleaded gasoline in St. John's based on historical numbers over the selected period. A similar exercise was completed for the other grades of gasoline, automotive diesel fuel, and No. 2 heating oil (furnace fuel) to establish initial base prices for these products at St. John's. The base price for stove oil was established by a reference differential of 1.8 cents per litre above the furnace oil price, which had been the traditional difference in wholesale or rack pickup prices for these products in Halifax as published by the OBG.

The base price for propane as a heating fuel was established by comparing the historic price of propane at the Sarnia rack with the corresponding delivered ex-tax retail price in St. John's. No base price was established for propane used as motor fuel due to its negligible use in the province as a retail product.

## **2.4 Establishment of Pricing Zones**

The next step in the process was to establish initial base prices for defined geographic pricing zones throughout the province. These zones were established based on historic pricing differentials from the St. John's area with some adjustments made to reflect more current storage and transportation cost structures. One of the guiding factors in establishing pricing zones was to keep their number to a minimum, albeit still consistent with a rational delineation of geographic areas and population. Fourteen primary pricing zones were initially established. In addition, based on identified unique circumstances (such as transportation cost to various islands and remote communities), a number of pricing sub-zones were, or have since been, added within some of the primary zones.

Since the PPPC established its initial maximum prices in the fall of 2001, the Commissioner received representations from a number of stakeholders concerning the pricing differentials

used between certain zones and /or sub-zones. The Avalon Peninsula, which includes the capital city of St. John's and encompasses close to half of the province's population, was designated as Zone 1. In the main, differentials established for other areas were referenced to that Zone. Since that time, some consumers have argued that differentials between certain zones are too high while conversely some suppliers maintain they are not sufficient to cover the additional costs involved, particularly in servicing the more remote areas of the province.

### **3.0 A Study of Storage and Distribution Costs for Petroleum Products**

#### **3.1 Study Impetus**

The Petroleum Products Pricing Commission has to date undertaken considerable affirmative action and measures to understand the dynamics of the market place, and to quantify factors affecting maximum prices established for regulated products in the province. Detailed implementation work has been undertaken to give effect to the legislation as prescribed.

In past dialogue with the PPPC, oil companies have made representations that the market for regulated products was competitive prior to regulation and the relatively high consumer prices were attributable to the higher costs of doing business in the province. Companies have pointed to factors such as high marine freight rates, expensive storage facilities (with increased operation costs due in large part to more stringent environmental requirements and insurance costs), and high distribution costs exacerbated by low volume throughputs in many areas due to a widely dispersed population.

Oil companies have continued to argue that the regulation process and high operating costs are having significant negative impacts on the level of financial returns that would sustain long term viability of their operations. As a result, and in a effort to be fair to all stakeholders, the PPPC determined that its affirmative action agenda required a closer examination of identified cost factors that are involved in transporting, storing and distributing regulated products to consumers. These costs include marine tanker freight; marine terminal storage and handling; distance truck haulage; bulk plant storage and handling; tank-wagon delivery and other direct costs associated with getting product to the point of sale for the end consumer.

Pricing zones and the relative pricing differentials between them are an integral part of the regulatory process and their re-examination built on sound and detailed cost analyses provided the impetus for this Study.

#### **3.2 Study - Request for Proposals**

The PPPC released a *Request for Proposals*, which outlined the purpose and scope of the Study as follows:

##### **(1) Review of Number of Zones and Zone Boundaries:**

*Using the information collected for this study, the consultant will review, analyze and confirm existing pricing zone boundaries or recommend revised boundaries for existing, additional, or fewer zones that more accurately reflect the current mode(s) of supplying regulated petroleum products to each area.*