

# REPORT OF THE AUDITOR GENERAL

*Petroleum Product Pricing:  
Prince Edward Island Regulatory  
and Appeals Commission*



**AUDITOR GENERAL**  
Prince Edward Island

**2018**



# Prince Edward Island Île-du-Prince-Édouard

## Office of the Auditor General

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The Honourable Speaker and  
Members of the Legislative Assembly  
Province of Prince Edward Island

I have the honour of presenting my report entitled "Petroleum Product Pricing:  
Prince Edward Island Regulatory and Appeals Commission".

This report was prepared in response to a request from the Legislative Audit  
Committee, a standing committee of the Legislative Assembly established under  
Section 2 of the *Audit Act*.

Respectfully submitted,

A handwritten signature in black ink, reading "B. Jane MacAdam".

B. Jane MacAdam, FCPA, CA  
Auditor General

Charlottetown, Prince Edward Island  
December 21, 2018

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## Table of Contents

SECTION	PAGE
1. Summary Comments .....	1
2. Background .....	2
3. IRAC's Petroleum Pricing Process .....	12
• Semi-Monthly Pricing	
• Unscheduled Price Adjustments	
4. Petroleum Pricing Framework .....	15
• Summary of Findings	
• Methodology	
• Price Changes	
• Price Interruption	
5. Wholesale and Retail Margins .....	20
• Summary of Findings	
• Margin Application Review	
6. Conclusion .....	23
<b>Appendix A - Recommendations and Commission Response</b>	
<b>Appendix B - Comparison of Gasoline Prices in Atlantic Provinces</b>	
<b>Appendix C - Comparison of Diesel Prices in Atlantic Provinces</b>	
<b>Appendix D - Comparison of Furnace Oil Prices in Atlantic Provinces</b>	
<b>Appendix E - Glossary of Terms</b>	
<b>Appendix F - Audit Standards, Objectives and Scope</b>	
<b>Appendix G - Audit Criteria</b>	

**SUMMARY COMMENTS**

**1.1** Our Office was requested by the Legislative Audit Committee to conduct an examination of the Prince Edward Island Regulatory and Appeals Commission (IRAC). The Legislative Audit Committee includes the Minister of Finance, the Leader of the Opposition, and the Speaker of the Legislative Assembly, who is Chair.

**1.2** IRAC is a quasi-judicial tribunal with broad powers conferred to it through the *Island Regulatory and Appeals Commission Act* as well as responsibilities under a number of other Acts. We focused our audit on one specific aspect of IRAC's responsibilities: petroleum product pricing.

**1.3** Petroleum pricing affects all Islanders. The decision to regulate petroleum pricing is a public policy decision. IRAC has a mandate under the *Petroleum Products Act* for determining petroleum prices that are fair and reasonable. This audit examined the processes followed by IRAC for the pricing of gasoline, diesel and furnace oil. We did not assess the merits of any petroleum pricing decision.

**1.4** Key aspects of other provinces' regulatory frameworks are presented in this report for information and comparison. Our work did not include an evaluation of any of these other frameworks in relation to PEI.

**1.5** The summary findings from our audit are as follows:

- IRAC developed a process for the regular review of petroleum prices. This process was not documented and formally approved as a policy of the Commission, nor was it transparent to Islanders.
- IRAC met at least semi-monthly to review petroleum prices; however, the key factors to support each price change decision were not adequately documented and transparent to the public.
- IRAC could not demonstrate that it formally reviewed prices and considered a price adjustment when market price changes warranted such a review based on its interruption policy.

- Applications from retailers for margin reviews were not processed on a timely basis.

**1.6** The Legislature gave IRAC broad powers under legislation for determining petroleum prices that are fair and reasonable. As a quasi-judicial body, IRAC should have sufficient documentation to demonstrate how it interprets and applies these broad powers in fulfilling its mandate. Further, IRAC needs to be more transparent to Islanders on how it sets petroleum prices and the key factors supporting each price change. This report includes seven recommendations which are listed in **Appendix A**.

**1.7** The scope of our audit covered the period April 1, 2016 to March 31, 2018. Subsequent to March 31, 2018, provincial legislative amendments were made that impact taxes on gasoline and diesel products. These changes take effect in calendar year 2019.

## BACKGROUND

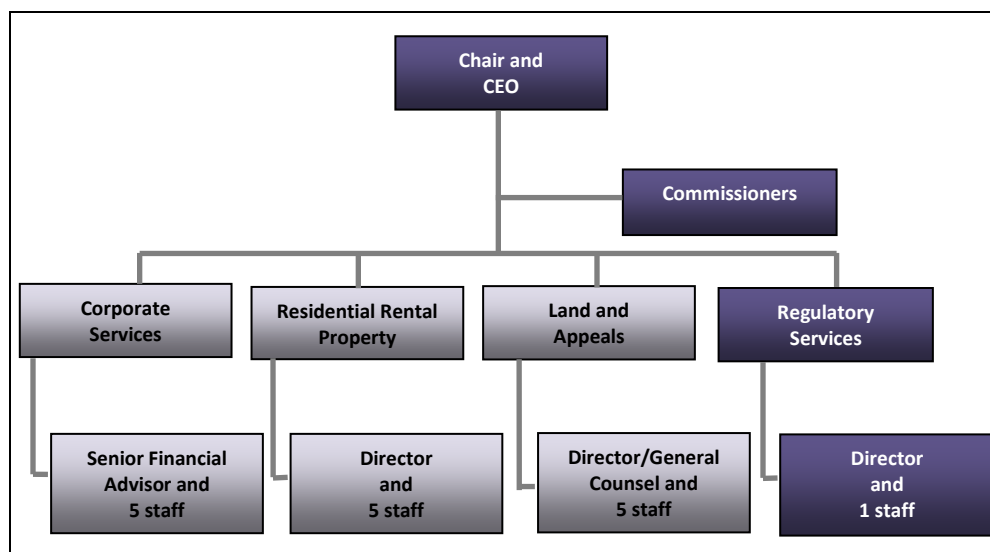
**2.1** Petroleum products are an essential commodity with a significant impact on the Island economy. The cost of fuel affects all Islanders. In 2017, there were over 219 million litres of gasoline sold in PEI and Islanders and visitors spent approximately \$239 million on gasoline. Further, almost 70 percent of Island households were heated with furnace oil costing Islanders approximately \$96 million. Petroleum products are also a significant input cost to major industries in PEI such as agriculture and fisheries.

**2.2** Petroleum product pricing is regulated by the Prince Edward Island Regulatory and Appeals Commission (IRAC), an independent quasi-judicial tribunal operating under the authority of the *Island Regulatory and Appeals Commission Act*. IRAC administers a number of provincial statutes dealing with regulatory matters including the *Petroleum Products Act*.

2.3 IRAC was established in 1991 following the amalgamation of the former Public Utilities Commission, Land Use Commission, and the Office of the Director of Residential Rental Property. It operates at arm's-length from the provincial government and reports to the Legislative Assembly through the Minister of Education, Early Learning and Culture.

2.4 The Lieutenant Governor in Council appoints members to the Commission. At the time of our audit, IRAC had 3 full-time Commissioners and two part-time Commissioners. IRAC had approximately 20 staff, each assigned to one of the four operating divisions as depicted in **Exhibit 2.1**. IRAC's annual operating expenditures of approximately \$3 million are funded by fees collected for licenses and permits, regulatory assessments, and an appropriation from the provincial government.

**EXHIBIT 2.1**  
**ORGANIZATION CHART**  
**ISLAND REGULATORY AND APPEALS COMMISSION**  
**OCTOBER 31, 2018**



Source: Adapted from IRAC website

2.5 Under the *Petroleum Products Act* (the Act), IRAC is responsible to regulate the distribution and sale of petroleum products within PEI. The Act also requires IRAC to ensure at all times a just and reasonable

price for heating fuel and motor fuel to consumers and licensees in the province.

**2.6** IRAC regulates the prices for gasoline, diesel, stove oil, furnace oil and most propane products sold within PEI. Minimum and maximum prices are set for retail gasoline and diesel products, and only maximum prices are set for furnace oil, stove oil, and propane products.

**2.7** IRAC's Regulatory Services Division supports the Commission in many areas, including price setting for petroleum products as well as retail and wholesale petroleum licensing. At the time of our audit, there were approximately 190 licensed retail petroleum product outlets in PEI including service stations as well as marine and propane outlets. In addition, there were 21 wholesale dealers licensed to sell various petroleum products.

**2.8** Petroleum products are sold to consumers in PEI from retailers<sup>1</sup> via an extensive supply chain that begins with crude oil<sup>2</sup>; however, the prices consumers pay are based on the refined gasoline product prices on the New York Mercantile Exchange (NYMEX)<sup>3</sup>, not crude oil prices.

**2.9** See **Exhibit 2.2** for a breakdown of the petroleum products supply chain.

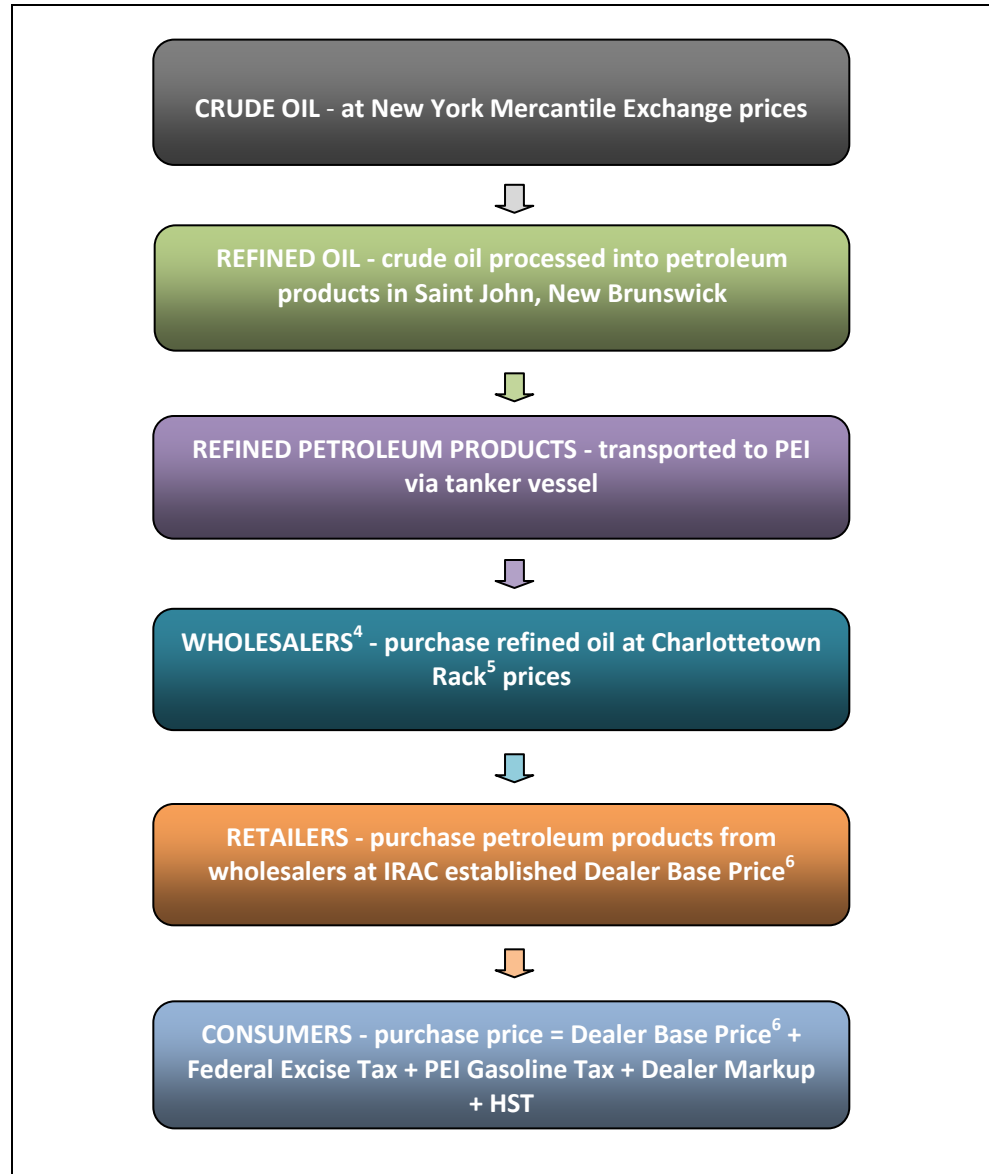
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<sup>1</sup>**Retailer** - Any person or company who sells any petroleum product or keeps any petroleum product for sale directly to consumers.

<sup>2</sup>**Crude Oil** - Crude oil is a naturally occurring, unrefined petroleum product composed of hydrocarbon deposits and other organic materials. A type of fossil fuel, crude oil can be refined to produce usable products such as gasoline, diesel and various forms of petrochemicals.

<sup>3</sup>**New York Mercantile Exchange (NYMEX)** - the world's largest physical commodity futures exchange.

**EXHIBIT 2.2**  
**PEI PETROLEUM PRODUCTS SUPPLY CHAIN**  
**GASOLINE AND DIESEL**



Source: Derived from information obtained from IRAC

<sup>4</sup>**Wholesaler** - A person or company that sells petroleum products directly to retailers.

<sup>5</sup>**Charlottetown Rack Price** - A location specific industry term which includes the overhead cost and profit margin of the refinery and transportation costs to Charlottetown, PEI.

<sup>6</sup>**Dealer Base Price** - The base price for petroleum products established by IRAC which includes the Charlottetown Rack price plus IRAC authorized wholesale margins. Taxes and dealer markups are applied to this price to determine the final price to consumers.



**GASOLINE AND  
DIESEL**

**2.10** IRAC sets the dealer base price of petroleum products for PEI. The dealer base price is the price paid by retailers for the products that are sold to Island consumers. These base prices are determined in part on the market prices of the refined product as well as wholesaler margins for each type of petroleum product. At the time of our audit, IRAC was committed to ensuring that wholesalers of gasoline and diesel receive a minimum margin of 5 cents per litre.

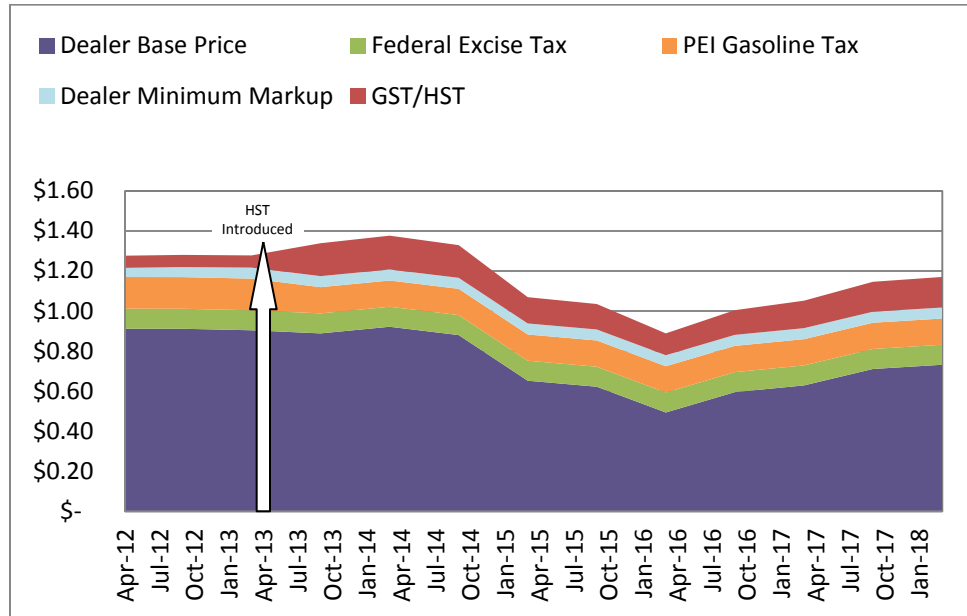
**2.11** Retail margins are established by IRAC. Gasoline and diesel have a minimum and maximum retail markup. At the time of our audit, the minimum markup was 5.5 cents per litre and the maximum markup was 6.5 cents per litre for self-serve gasoline and diesel.

*Gasoline*

**2.12** After the dealer base price is established, taxes are added. The federal excise tax and provincial gasoline tax are set by the respective governments and are not controlled by IRAC. At the time of our audit, the federal excise tax was fixed at 10 cents per litre for all gasoline products. The PEI gasoline tax was fixed at 13.1 cents per litre. These taxes do not change as the dealer base price of gasoline fluctuates. Finally, the harmonized sales tax (HST) is applied to all the other components including the other taxes. The HST is the only component of the price that is not set at a fixed amount per litre. At the time of our audit, HST was 15 percent.

**2.13** **Exhibit 2.3** illustrates the components of unleaded gasoline prices in PEI during the period April 2012 to March 2018. Prior to April 2013, Islanders did not pay provincial sales tax on gasoline; only Goods and Services Tax (GST) of 5 percent was applied. In April 2013, HST was introduced at 14 percent and increased to 15 percent on October 1, 2016.

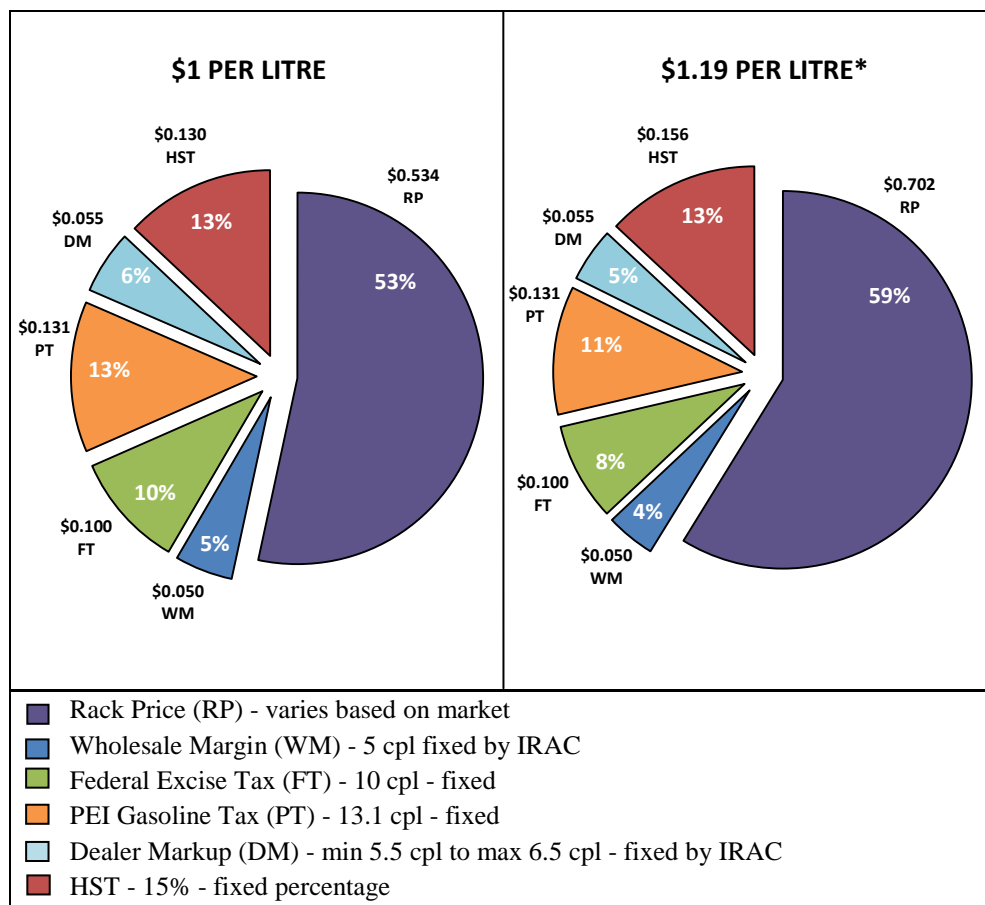
**EXHIBIT 2.3**  
**PRICING COMPONENTS TIMELINE**  
**SELF-SERVE REGULAR UNLEADED GASOLINE**



Source: Derived from IRAC information

**2.14 Exhibit 2.4** provides a breakdown of the components of regular unleaded, self-serve gasoline prices based on \$1 per litre and \$1.19 per litre, the price in effect at March 31, 2018. As the exhibit demonstrates, when the price of gasoline increases, the percentage of the total purchase price that is taxes decreases. At \$1.00 per litre, total taxes represented 36 percent of the total purchase price, and at \$1.19 per litre 32 percent of the total purchase price was taxes.

**EXHIBIT 2.4  
BREAKDOWN OF FUEL PRICE  
REGULAR UNLEADED SELF-SERVE GASOLINE  
MARCH 31, 2018**



Source: Derived from IRAC information

cpl = cents per litre

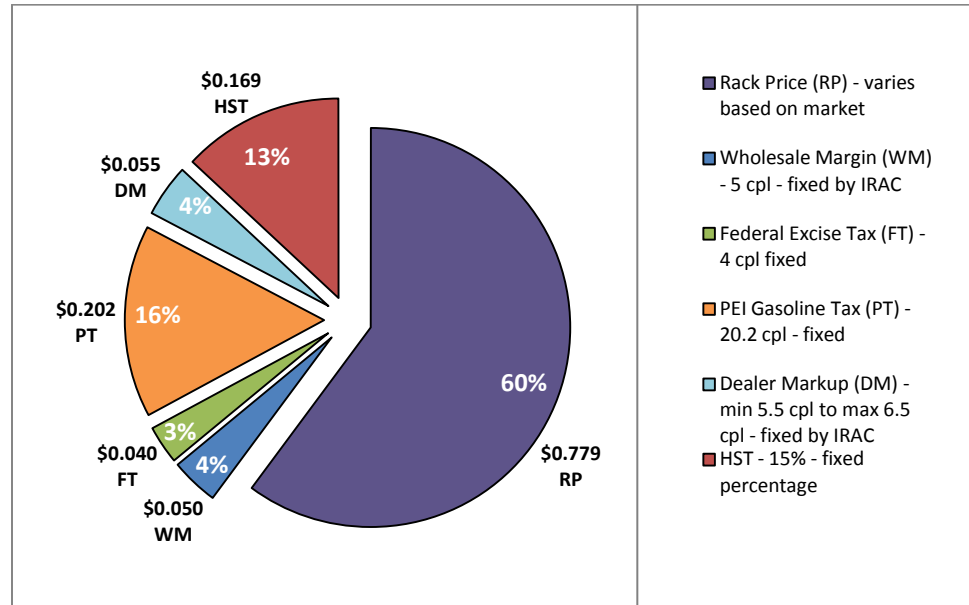
\*Price at March 31, 2018

*Diesel*

**2.15** The regulation of diesel and gasoline is very similar in PEI. The only difference is the amount of the fixed taxes applied to each product. At the time of our audit, the federal excise tax on diesel fuel was 4 cents per litre and the PEI gasoline tax on diesel was 20.2 cents per litre. Similar to gasoline, HST of 15 percent is also applied to all components of the price. **Exhibit 2.5** shows a breakdown of the components of diesel prices at March 31, 2018. When the cost of diesel was \$1.295 per litre, the percentage of the total price paid in taxes was 32 percent. Similar to

gasoline, as the price for diesel increases, taxes as a percentage of the total purchase price decreases.

**EXHIBIT 2.5**  
**BREAKDOWN OF FUEL PRICE**  
**DIESEL SELF-SERVE AT \$1.295\* PER LITRE**  
**MARCH 31, 2018**

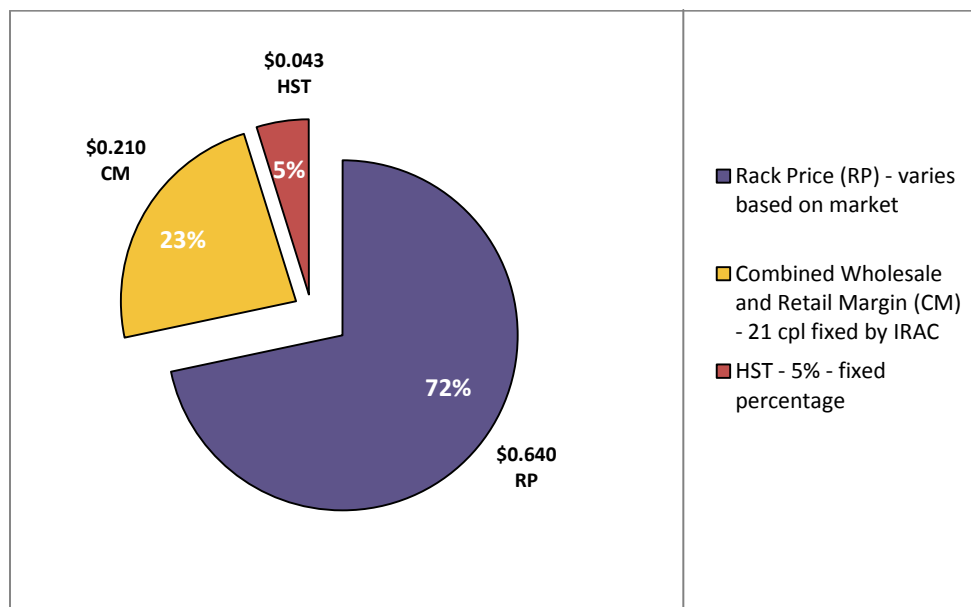


Source: Derived from IRAC information  
 cpl = cents per litre  
 \*Price at March 31, 2018

**FURNACE OIL**

**2.16** Furnace oil regulation is slightly different than the regulation of other petroleum products in PEI. The approved margin is a combination of both wholesale and retail markup. At the time of our audit, the combined wholesale and retail margin for furnace oil included in the dealer base price was 21 cents per litre. The price set by IRAC is the maximum that furnace oil dealers may charge. There is no minimum price established which gives furnace oil dealers flexibility to offer discounts to customers. In addition, only the federal government portion of the HST, or 5 percent, is added to consumers’ oil bills. **Exhibit 2.6** shows a breakdown of the components of furnace oil prices at March 31, 2018.

**EXHIBIT 2.6  
BREAKDOWN OF FUEL PRICE  
FURNACE OIL AT 89.3\* CENTS PER LITRE  
MARCH 31, 2018**



Source: Derived from IRAC information  
cpl = cents per litre  
\*Price at March 31, 2018

**PROPANE**

**2.17** Propane is also a regulated petroleum product in Prince Edward Island. IRAC obtains requests for price increases or decreases from each of the three propane dealers twice monthly. The application includes cost information on the rack price each dealer is paying for its product. The prices approved by IRAC are typically slightly different for each propane dealer.

**INFORMATION ON ATLANTIC REGULATION**

**2.18** Five Canadian provinces regulate some or all of the petroleum product prices within their jurisdiction. The five provinces include all Atlantic provinces as well as Quebec. Each Atlantic province has a different methodology for setting its respective prices, as depicted in **Exhibit 2.7**. In some cases, these differences are set within the respective legislation. Some provinces set maximum prices only, some set maximum and minimum prices on all products, and some do a combination of both. In addition, most provinces have formulas to set prices and all have

interruption clauses. All Atlantic provinces review prices weekly except for PEI.

**2.19** There are three main reasons for differences in pre-tax prices of petroleum products in Atlantic Canada. These include:

- differences in the base rack price;
- differences in allowable margins; and
- structural differences in how each province regulates.

**EXHIBIT 2.7**  
**REGULATION OF PETROLEUM PRODUCT PRICING**  
**COMPARISON TO OTHER ATLANTIC PROVINCES**  
**MARCH 31, 2018**

Province	Prince Edward Island	New Brunswick	Nova Scotia	Newfoundland and Labrador
<b>Petroleum Products Regulated</b>	1. Gasoline 2. Diesel 3. Furnace Oil 4. Propane	1. Gasoline 2. Diesel 3. Furnace Oil 4. Propane	1. Gasoline 2. Diesel	1. Gasoline 2. Diesel 3. Furnace Oil 4. Propane
<b>Minimum and Maximum Prices</b>	1. Gasoline - Both 2. Diesel - Both 3. Furnace Oil - Maximum Only 4. Propane - Maximum Only	Maximum Prices Only	1. Gasoline - Both 2. Diesel - Both	Maximum Prices Only
<b>Formula Based</b>	No*	Yes	Yes**	Yes
<b>Frequency of Regular Price Reviews</b>	Semi-Monthly	Weekly	Weekly	Weekly
<b>Price Interruption Clause</b>	Yes	Yes	Yes	Yes

Source: respective jurisdictional websites

\*Quantitative model plus other factors

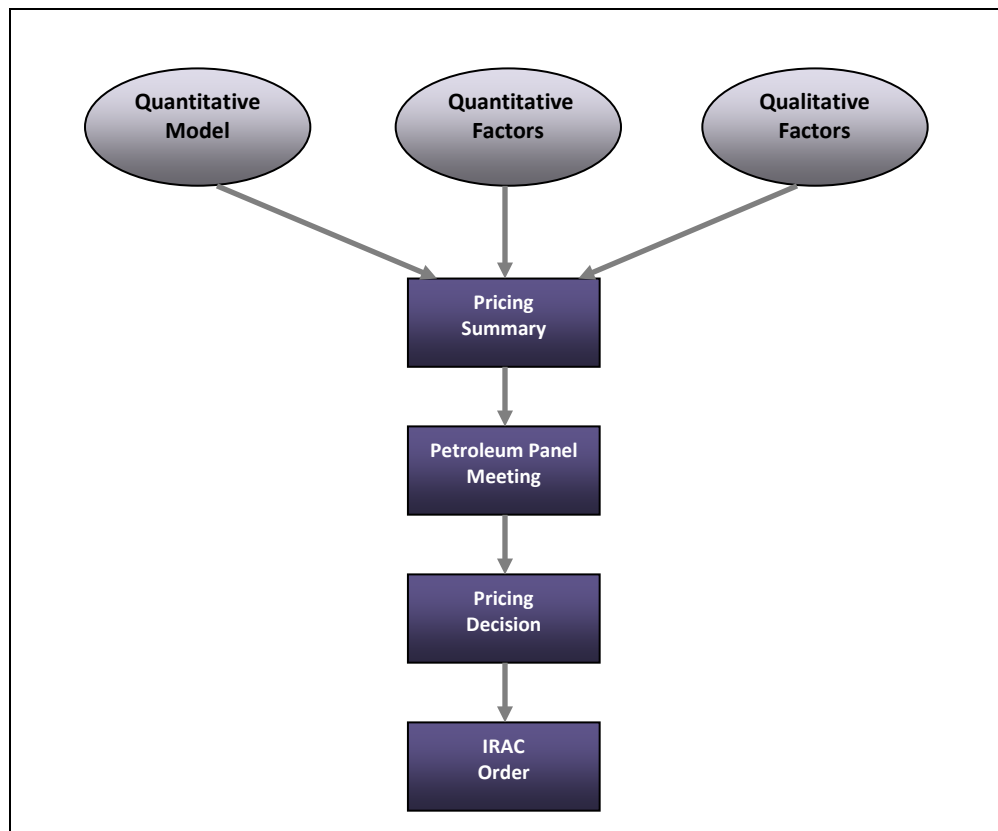
\*\*Formula plus adjustment to restore wholesale margin if required

**2.20 Appendices B, C, and D** provide a comparison of petroleum prices for selected cities in the Atlantic provinces from April 2016 to March 2018. These comparisons include prices for gasoline, diesel, and furnace oil including and excluding taxes.

**IRAC'S PETROLEUM PRICING PROCESS**

**3.1 Exhibit 3.1** provides a summary of the general process IRAC has established for reviewing petroleum product prices. This summary is applicable to IRAC's regularly scheduled, semi-monthly adjustments as well as unscheduled adjustments.

**EXHIBIT 3.1  
SUMMARY OF GENERAL PROCESS  
SCHEDULED AND UNSCHEDULED PRICE ADJUSTMENTS  
APRIL 2016 TO MARCH 2018**



Source: Prepared by OAG based on information from IRAC

**SEMI-MONTHLY  
PRICING**

**3.2** The *Petroleum Products Act* does not prescribe a methodology for petroleum price setting. IRAC has established a standardized approach to price setting which has evolved over time. The Petroleum Panel of the Commission meets semi-monthly to determine if price adjustments are warranted on the 1<sup>st</sup> and the 15<sup>th</sup> of each month.

**3.3** In preparation for the semi-monthly meeting, the Director of the Regulatory Services Division prepares and provides a pricing summary to the Commissioners on the Petroleum Panel. This document contains key quantitative and qualitative information for pricing decisions.

**3.4** IRAC staff gather daily market data that is used to populate a quantitative model. This model includes data on refined product pricing from the NYMEX and the Charlottetown Rack prices for each petroleum product: gasoline, diesel, and furnace oil. The pricing summary highlights:

- the difference between the Charlottetown Rack price and the IRAC dealer base price at the current date;
- the previous two week average difference of Charlottetown Rack price and the IRAC dealer base price; and
- the annual average wholesale margin for each petroleum product for each of the previous four years.

**3.5** Other relevant quantitative information presented in the pricing summary includes:

- Current pump prices - gasoline, diesel, and furnace oil prices are provided for Charlottetown and major cities across Canada.
- Crude oil and refined product analysis - statistics and trend analysis on the price for crude oil and refined products.

**3.6** Qualitative information is included in the pricing summary. This information could include developments that may impact the market and inventory levels. Examples of relevant qualitative information used by IRAC include:



- information on national and international events such as extreme weather, and political issues in large oil producing countries;
- the change of the Canadian dollar in the currency markets;
- seasonal changes in the demand for different petroleum products and the potential impact on wholesale margins; and
- market information from recognized sources, such as Bloomberg.

**3.7** The Director of Regulatory Services presents the pricing summary and provides a pricing recommendation to the Commissioners for each petroleum product. After discussion and consideration of information, the Commissioners decide on the prices for gasoline, diesel, and furnace oil and the order establishing the price is signed by the Commissioners. IRAC is required under legislation to have all decisions of the Commission approved by a minimum of two Commissioners.

**3.8** The approved price is communicated to the industry prior to the official announcement to the general public. IRAC prepares a press release and posts the order on its website. The price change is effective at midnight on the 1<sup>st</sup> and 15<sup>th</sup> of each month or the date specified in the order if the adjustment is unscheduled.

**UNSCHEDULED  
PRICE  
ADJUSTMENTS**

**3.9** IRAC sets petroleum prices semi-monthly, but also has an interruption policy to allow for price changes to one or more of the petroleum products in times of extreme volatility in the market. IRAC approved this policy in 2008.

**3.10** IRAC's policy states that IRAC will "formally review approved prices and consider an unscheduled interruption when a change of +/- 4.0 cents per litre has occurred in the average price of any of the regulated products of gasoline, diesel and furnace oil and that such change has been sustained for a period of 5 days".

**3.11** In other words, when an interruption to the pricing is triggered the Petroleum Panel is required to formally review prices, but this may not result in a price change. When the Panel meets, the process is the same as for regularly scheduled price changes.

**PETROLEUM PRICING FRAMEWORK**

**SUMMARY OF FINDINGS**

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**4.1** The process used by IRAC to set petroleum prices was not documented and not formally approved as a policy of the Commission. IRAC had a standardized approach to set petroleum prices, but it was not transparent. A current and complete document that outlines IRAC’s methodology for petroleum pricing was not publicly available. There was inadequate documentation available to Islanders on the key factors that supported each of IRAC’s price decisions. Further, there was insufficient documentation available to demonstrate that IRAC’s Petroleum Panel formally reviewed prices and considered a price adjustment when market prices changed significantly.

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**METHODOLOGY**

**4.2** The *Petroleum Products Act* (the Act) is the enabling legislation that provides authority for the regulation of petroleum products in PEI. The purpose of this Act is to “...ensure at all times a just and reasonable price for heating fuel and motor fuel to consumers and licensees within the province”. Under this Act, IRAC has broad powers to regulate petroleum products. Part III of the Act states that the Commission has the “authority to regulate the timing and frequency of price changes and.....the power to determine

- (a) the price and any change in the price of heating fuel and motor fuel; and
- (b) the minimum and maximum markup between the wholesale price to the retailer and the retail price to the consumer of heating fuel and motor fuel.”

**4.3** Further in Section 31 of the Act, IRAC shall apply criteria to be used to determine the price or a change in the price; however, the Act is not prescriptive on what these criteria should be.

**4.4** Given these broad powers for setting petroleum prices, we expected IRAC to have a documented methodology for setting petroleum prices and we expected this document to have formal, documented approval of the Commission. IRAC’s approach to setting petroleum

product prices should be clearly outlined and easily accessible to the public. We looked for transparency in the following areas:

- IRAC's methodology;
- key factors impacting each pricing decision; and
- approved prices.

### **Methodology not documented, approved in policy, or transparent**

**4.5** At the time of our audit, IRAC had a standardized process for regularly scheduled petroleum price adjustments, but it was not documented and not formally approved as a policy of the Commission. The description provided in this report is a compilation of multiple interviews of IRAC management and Commissioners, review of documentation, and attendance at a Petroleum Panel meeting.

**4.6** Nowhere could the public access a current and complete document that outlined IRAC's methodology for petroleum product pricing. IRAC's website contained some elements of a pricing methodology used to set petroleum pricing; however, this information was in various sections on the website including Frequently Asked Questions and old presentations. Some of the information on the website was outdated and not entirely reflective of the process. The approved markups for wholesalers of gasoline and diesel were not publicly available. Similarly, the combined wholesale and retail margin for furnace oil were also not publicly available. Even the approved interruption policy was not highlighted as a policy of petroleum pricing. It was included with all other orders of the Commission in 2008; the average taxpayer would not know this order existed. In the other jurisdictions in Atlantic Canada that regulate petroleum pricing, the methodology is publicly available, the regulation is formula based and available either in the jurisdictions' respective legislation or on the website of the regulating body.

**4.7** The price setting methodology should be documented and approved as a policy of the Commission. This methodology should be transparent to the public. Without an approved policy for price setting, there can be inconsistent decision making, a lack of continuity in the event

of employee turnover as well as a risk that new staff and Commissioners will misinterpret or not clearly understand the process. Petroleum pricing decisions affect all Islanders. An approved petroleum price setting policy that is transparent to the public would assist IRAC to demonstrate that it has set just and reasonable prices for consumers and licensees.

**Recommendations**

**4.8 IRAC should document and approve a policy on its methodology for setting petroleum prices.**

**4.9 IRAC should make its petroleum pricing methodology available to the public.**

**PRICE CHANGES**

**4.10** IRAC's pricing decisions are based on both quantitative and qualitative data. Quantitative data is primarily used to assess market conditions at the date of the meeting and to analyze the changes that occurred in the market over the prior two week period. Some of this data was included on the quantitative model which was available daily to the Petroleum Panel. The model included the Charlottetown Rack price, NYMEX prices, current IRAC base price as well as year-to-date weighted average wholesale margins for each petroleum product.

**4.11** We were advised qualitative data is primarily used by the Commission to assess the factors that may influence changes in market conditions up to the next scheduled pricing decision. Qualitative data was available to the Petroleum Panel either in the pricing summary prepared by the Director, through email updates from the Director, or through each Panel member's research.

**4.12** We selected a sample of 30 pricing meetings between April 2016 and March 2018. We looked for documentation to determine if IRAC's petroleum price setting process was consistently followed on each of these dates. We assessed whether:

- the Petroleum Panel met to consider a price change;
- pricing information was provided to the Petroleum Panel;

- documentation existed to indicate what specific factors supported each price decision;
- an official order was signed by two Commissioners for each price decision; and
- pricing decisions were communicated to stakeholders.

### **Prices authorized by the Commission and communicated to the public**

**4.13** For all of the sample items we examined, we noted that the Petroleum Panel formally met to consider each price change and relevant pricing information was provided to the Panel for consideration. For the decisions examined, we noted that all pricing orders were signed by a minimum of two Commissioners as required by legislation. When the Petroleum Panel decided on a price change, both regularly scheduled and interrupted, the price changes were communicated to the public through an official order of the Commission as well as a press release. Both documents are available on IRAC's website.

### **Price change rationale not transparent**

**4.14** We were advised the starting point of a price decision was the quantitative model, specifically the previous two-week average of the Charlottetown Rack price plus the target wholesale margin. Most of the time, this calculation did not agree to the final price decision of the Panel. In most of the pricing decisions we examined for gasoline, diesel and furnace oil, the Petroleum Panel made an additional adjustment to arrive at the final price. However, there was inadequate documentation, either maintained internally or provided to the public, on the specific quantitative and qualitative factors that supported each price change.

**4.15** In the press releases, it was common to see an explanation for an increase to prices "due to increased demand and restricted supply." The communications to the public should include the specific key factors that impacted each change in price, such as:

- the impact of the NYMEX and the Charlottetown Rack prices;
- the impact of restoring wholesaler margins;

- the impact of inventory levels; and
- the expected impact of global events on crude oil prices and refined oil prices.

**4.16** Transparency is essential for the public to understand the merits of any pricing decision. The key factors that support each pricing decision of the Commission should be clearly communicated to the public. After these issues were brought to the attention of management, we noted the Commission took action to include more information on the factors leading to price decisions in both the Commission minutes and press releases.

**Recommendation**

**4.17 IRAC should document the key factors that support each pricing decision and clearly communicate this information to the public.**

**PRICE  
INTERRUPTION**

**4.18** The purpose of an interruption policy in petroleum product pricing is to ensure prices are reviewed and adjusted if necessary when market prices become significantly and consistently out of line with current regulated prices. Such a policy is put in place to protect both licensees and consumers.

**4.19** We assessed IRAC's compliance with its interruption policy. At the time of our audit, the policy stated that the Commission will formally review and consider a price adjustment when a change has occurred in the average price of + or - 4 cents per litre and it is sustained for a five day period. As a quasi-judicial body, we would expect IRAC to maintain documentation on all formal pricing reviews.

**Insufficient documentation to support IRAC formally reviewed prices when price interruption was triggered**

**4.20** We found that IRAC did not retain sufficient documentation to demonstrate that the Commission formally reviewed prices in accordance with policy when interruption parameters were triggered. Over the two-

year scope period, market conditions resulted in an interruption being triggered for one or more products ten times. For 7 of the 10 times, there was inadequate documentation to support that the Petroleum Panel formally reviewed prices and considered a price adjustment when the interruption criteria were met. In all of these cases, the market conditions persisted for an additional one to six business days before a formal price review was documented.

**4.21** We were advised that Commissioners and staff continuously monitor PEI prices and relevant market indicators. In cases of extreme volatility in the market, the Petroleum Panel will sometimes meet to consider a price adjustment even when the interruption policy conditions have not been met. We noted six such meetings during our scope period.

**4.22** The price interruption policy was implemented by IRAC in 2008 in response to a request from licensees for weekly price adjustments. Without documentation of a formal review, it is not clear whether IRAC considered a price adjustment when significant market fluctuations triggered the price interruption criteria.

**Recommendation**

**4.23 IRAC should document its review of prices and its consideration of an unscheduled price adjustment when interruption criteria in its policy are met.**

**WHOLESALE AND RETAIL MARGINS**

**SUMMARY OF FINDINGS**

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**5.1** IRAC takes the position that provisions in the *Petroleum Products Act* that relate to applications for price changes are out of date; but, IRAC has not sought amendments to the Act. IRAC has not developed policies and procedures for processing applications from wholesalers and retailers for changes to margins. The two margin review applications we examined were not processed in a timely manner.

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**MARGIN  
APPLICATION  
REVIEW**

**5.2** As part of price regulation, IRAC controls the margins that wholesalers and retailers can charge on the petroleum products they sell. Section 27 of the *Petroleum Products Act* states that the Commission has the power to determine: “the minimum and maximum markup between the wholesale price to the retailer and the retail price to the consumer of heating fuel and motor fuel.”

**5.3** At the time of our audit, the target wholesale margin for gasoline and diesel was 5 cents per litre. We were advised by IRAC management that this margin had been in effect for more than 15 years. Management could not provide documented authorization of this margin. The retail margin for self-serve gasoline and diesel was set at a minimum of 5.5 cents per litre and a maximum of 6.5 cents per litre. These retail margins were approved by an order of the Commission in March 2012.

**5.4** The combined wholesale/retail margin for furnace oil was increased from 19.5 to 21 cents per litre in July 2017. The decision to approve the furnace oil margin increase was recorded in the minutes of the Commission.

**No documented policies on margin reviews**

**5.5** As a quasi-judicial tribunal, IRAC takes the position that it has considerable leeway to give effect to its regulatory mandate. IRAC also takes the position that legislative provisions that relate to applications on price changes are out of date. Management advised that although it had discussions with government regarding the *Petroleum Products Act*, as of the date of our audit report, IRAC had not sought amendments to the Act.

**5.6** IRAC’s practice, at the time of our audit, was to review margin applications as they were received. However, IRAC had not developed policies and procedures for review of margins and there was no clear information available to applicants on the process.



**Applications for margin reviews not processed on a timely basis**

**5.7** We examined the two most recent margin applications received by IRAC. The first application, from an association representing a group of furnace oil retailers, was received by IRAC on August 27, 2015. On October 19, 2016, almost 14 months after the receipt of the application, the Commission made a decision to engage a consulting company to conduct a financial analysis to assist in IRAC's consideration of the application. The report from the consultant was received by the Commission in February 2017. IRAC agreed to increase furnace oil margins by 1.5 cents per litre on July 20, 2017. We noted that 23 months, almost two years, had passed from the date the application was received to the date of the decision.

**5.8** On October 26, 2016, an application for a margin increase was received from an association representing a group of retail gasoline dealers. IRAC contacted the group on July 26, 2018, 21 months after it was received, to gather information to assist in its preliminary assessment. As of the date of our audit, no decision had been made by IRAC on this application.

**5.9** Overall, applications for margin reviews were not being processed by IRAC on a timely basis. The Commission is responsible for ensuring a fair and reasonable price for consumers as well as retailers and wholesalers. IRAC has the authority and obligation to develop and document policies and procedures that are transparent to applicants and provide for the timely review of margin applications.

**Recommendations**

**5.10** IRAC should seek any necessary amendments to the *Petroleum Products Act*.

**5.11 IRAC should develop and document policies and procedures for determining fair and reasonable margins for wholesalers and retailers.**

**5.12 IRAC's process for assessing and reviewing applications for margin increases should be transparent to wholesalers and retailers.**

## CONCLUSION

**6.1** IRAC is a quasi-judicial tribunal that was given broad powers under the *Petroleum Products Act* to set just and reasonable petroleum prices for consumers and licensees. The Commission has authority to establish the policies and procedures it deems appropriate for fulfilling this mandate.

**6.2** IRAC had a standardized process for setting petroleum product prices on the 1<sup>st</sup> and 15<sup>th</sup> of each month. Relevant quantitative and qualitative information was available to the Petroleum Panel for consideration at pricing meetings. This process was not documented and formally approved as a policy of the Commission, nor was it transparent to Islanders. Nowhere could the public access a current and complete document explaining IRAC's petroleum price setting methodology.

**6.3** The key factors that supported each price change approved by IRAC were not adequately documented and were not transparent to the public. IRAC was unable to demonstrate that it formally reviewed prices and considered an unscheduled price change in accordance with its interruption policy during the scope period of our audit.

**6.4** IRAC did not develop and document policies for the review of applications from wholesalers and retailers for changes to margins. Margin applications were not being reviewed on a timely basis.

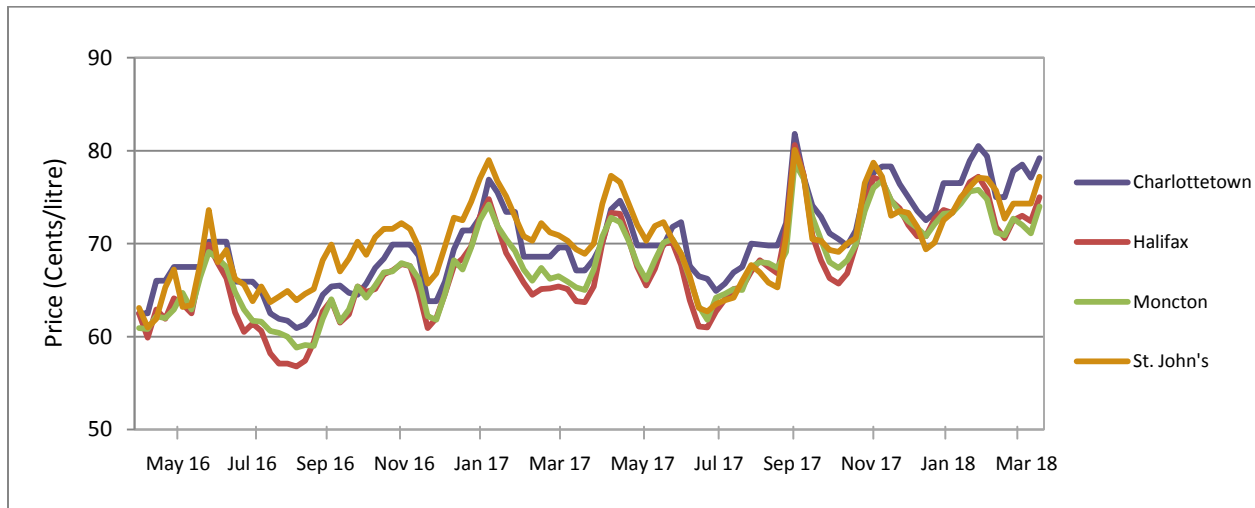
RECOMMENDATION*	COMMISSION RESPONSE
<p><b>Recommendation 4.8</b> IRAC should document and approve a policy on its methodology for setting petroleum prices.</p>	<p><i>On December 14, 2018, the Commission formally documented its existing Petroleum Pricing Methodology as recommended.</i></p>
<p><b>Recommendation 4.9</b> IRAC should make its petroleum product pricing methodology available to the public.</p>	<p><i>On December 14, 2018, the Commission determined to publish the Petroleum Pricing Methodology on the Petroleum page of the Commission website and to make the documented Methodology available to licensees, consumers, and the general public in such manner as may be necessary.</i></p> <p><i>On December 19, 2018, the Commission published the Petroleum Pricing Methodology on its website.</i></p>
<p><b>Recommendation 4.17</b> IRAC should document the key factors that support each pricing decision and clearly communicate this information to the public.</p>	<p><i>The Commission does document and communicate the factors that support each pricing decision.</i></p> <p><i>On December 14, 2018, the Commission resolved to have staff initiate and conduct a review of the Commission’s existing practice of documentation and communication of petroleum pricing decisions.</i></p> <p><i>Commission staff were also directed to work with the Commission’s new Senior Communications Officer to develop a communication strategy to inform licensees, consumers, and the general public of the key factors that support each pricing decision.</i></p>
<p><b>Recommendation 4.23</b> IRAC should document its review of prices and its consideration of an unscheduled price adjustment when interruption criteria in its policy are met.</p>	<p><i>On December 14, 2018, the Commission reviewed its existing policy (Commission Order PC 08-01) and practices related to unscheduled petroleum pricing adjustments and interruption criteria.</i></p> <p><i>On December 14, 2018, the Commission adopted a revised policy related to unscheduled petroleum pricing adjustments.</i></p>

RECOMMENDATION*	COMMISSION RESPONSE
<p><b>Recommendation 5.10</b>                      IRAC should seek any necessary amendments to the <i>Petroleum Products Act</i>.</p>	<p><i>On December 14, 2018, the Chair sent correspondence to the Director of Legal Services requesting amendments to the Petroleum Products Act.</i></p> <p><i>The Commission will continue to review the Petroleum Products Act and seek any necessary amendments.</i></p>
<p><b>Recommendation 5.11</b>                      IRAC should develop and document policies and procedures for determining fair and reasonable margins for wholesalers and retailers.</p>	<p><i>On December 14, 2018, the Commission Chair updated the Petroleum Pricing Panel with respect to discussions he initiated with other Atlantic Canadian regulators.</i></p> <p><i>The four Atlantic Canadian regulators have agreed to meet in the spring of 2019 (date to be determined) to review existing practices with respect to Margin Application.</i></p> <p><i>Commission staff were directed to continue development of draft policies and procedures related to Margin Applications for consideration by the Petroleum Panel, for presentation at the regional meeting and subsequent adoption by the Panel.</i></p>
<p><b>Recommendation 5.12</b>                      IRAC’s process for assessing and reviewing applications for margin increases should be transparent to wholesalers and retailers.</p>	<p><i>On December 14, 2018, the Chair advised the Petroleum Pricing Panel that the policies and procedures related to Margin Applications to be developed for presentation at the regional regulators meeting and then presented for adoption by the Panel, will be published and made available to licensees, consumers, and the general public.</i></p>

\*Note: Recommendation numbers refer to the paragraph number in the body of the report.

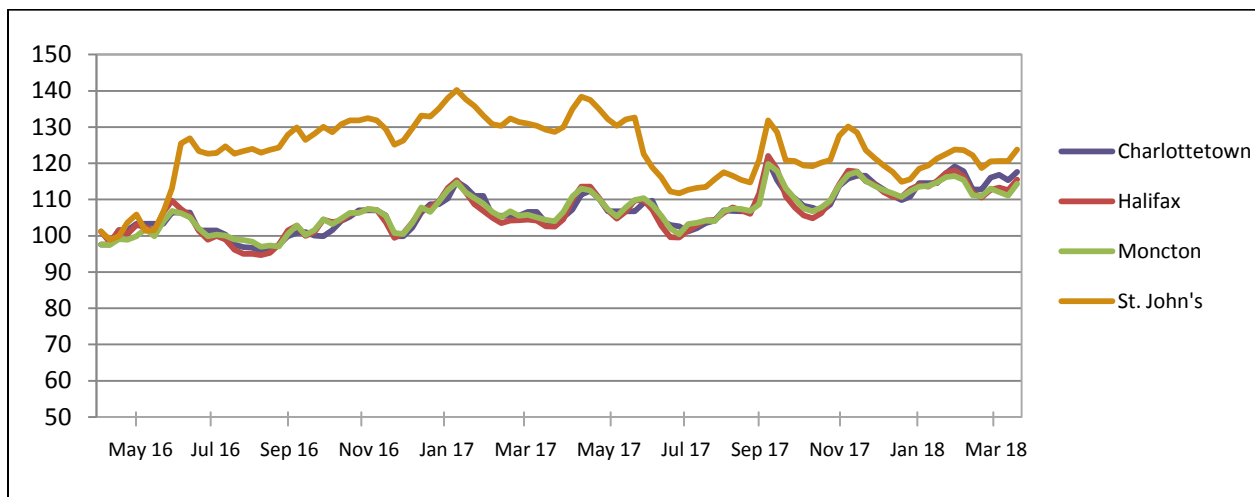
**COMPARISON OF GASOLINE PRICES IN ATLANTIC PROVINCES**

**RETAIL UNLEADED GASOLINE PRICES EXCLUDING TAXES  
APRIL 2016 TO MARCH 2018**



Source: Kent Group Limited - Weekly weighted average price based on data obtained from retailers.

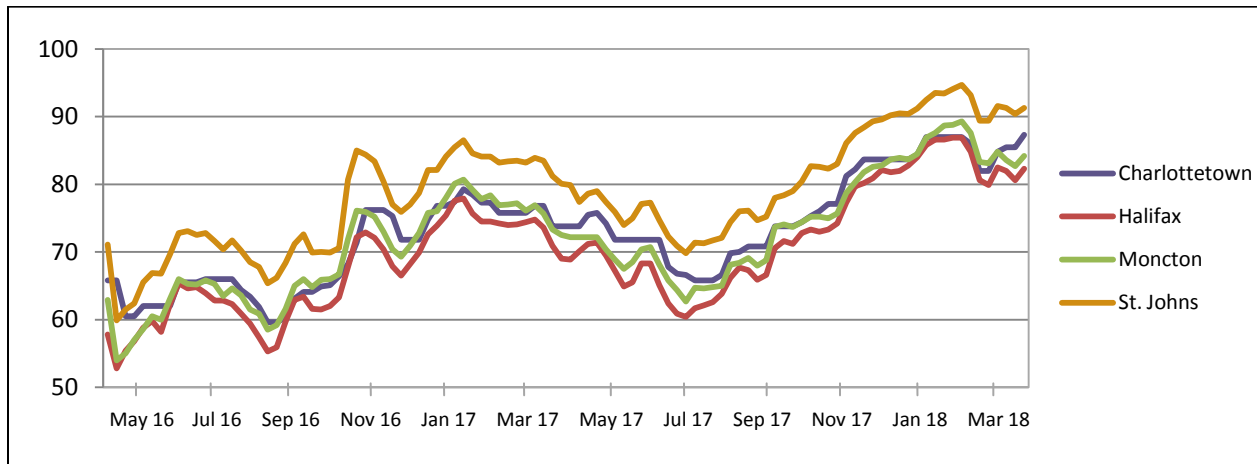
**RETAIL UNLEADED GASOLINE PRICES INCLUDING TAXES  
APRIL 2016 TO MARCH 2018**



Source: Kent Group Limited - Weekly weighted average price based on data obtained from retailers.

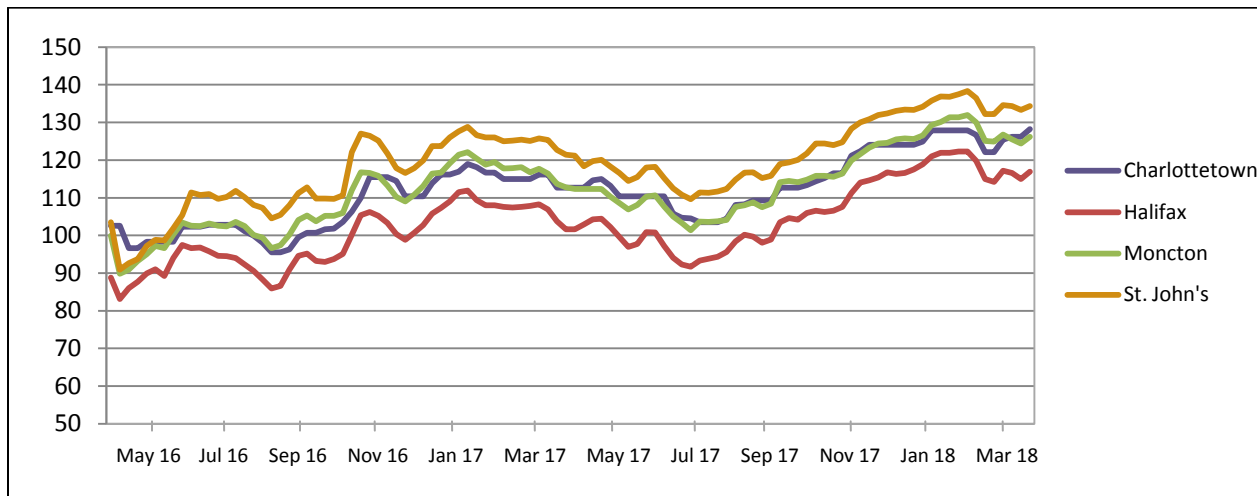
**COMPARISON OF DIESEL PRICES IN ATLANTIC PROVINCES**

**DIESEL PRICES EXCLUDING TAXES  
APRIL 2016 TO MARCH 2018**



Source: Kent Group Limited - Weekly weighted average price based on data obtained from retailers.

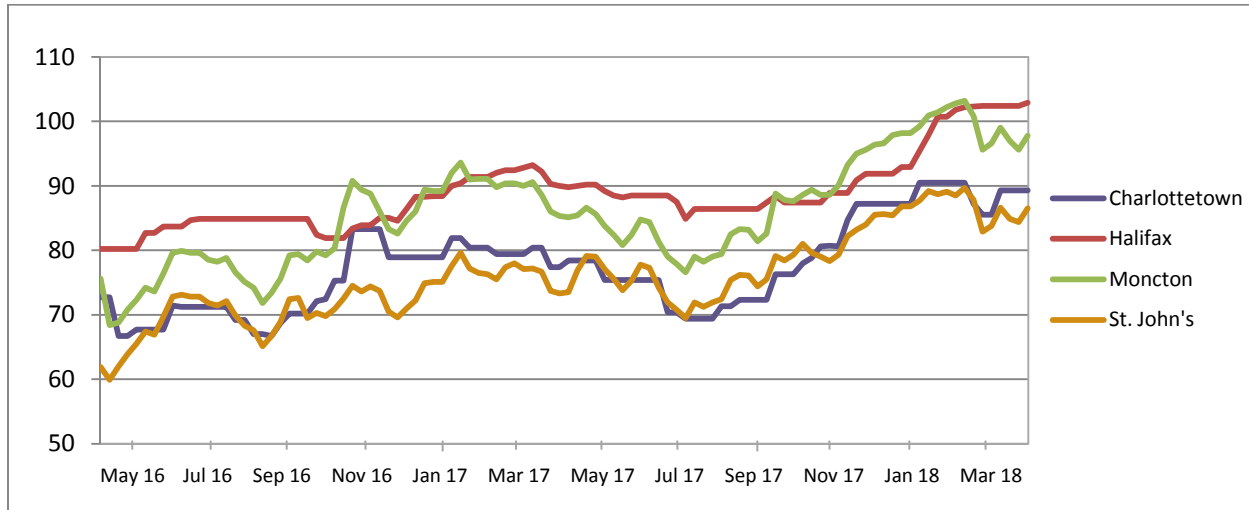
**DIESEL PRICES INCLUDING TAXES  
APRIL 2016 TO MARCH 2018**



Source: Kent Group Limited - Weekly weighted average price based on data obtained from retailers.

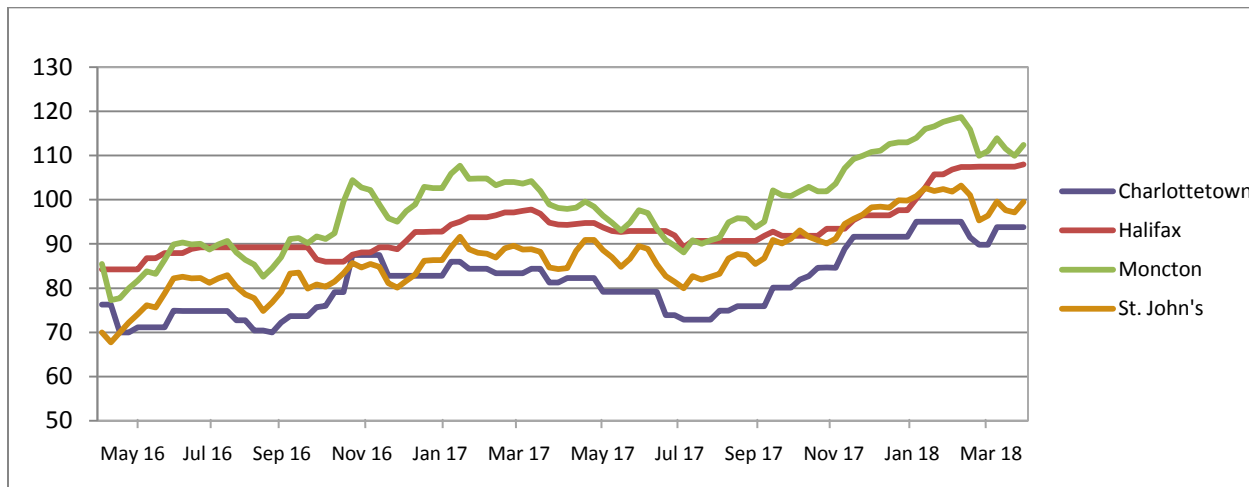
**COMPARISON OF FURNACE OIL PRICES IN ATLANTIC PROVINCES**

**FURNACE OIL PRICES EXCLUDING TAXES  
APRIL 2016 TO MARCH 2018**



Source: Kent Group Limited - Weekly weighted average price based on data obtained from retailers.  
\*Nova Scotia does not regulate furnace oil pricing.

**FURNACE OIL PRICES INCLUDING TAXES  
APRIL 2016 TO MARCH 2018**



Source: Kent Group Limited - Weekly weighted average price based on data obtained from retailers.  
\*Nova Scotia does not regulate furnace oil pricing.

## APPENDIX E

### GLOSSARY OF TERMS

- **Charlottetown Rack Price** - A location specific industry term which includes the overhead cost and profit margin of the refinery and transportation costs to Charlottetown, PEI.
- **Crude Oil** - Crude oil is a naturally occurring, unrefined petroleum product composed of hydrocarbon deposits and other organic materials. A type of fossil fuel, crude oil can be refined to produce usable products such as gasoline, diesel and various forms of petrochemicals.
- **Dealer Base Price** - The base price for petroleum products established by IRAC which includes the Charlottetown Rack price plus IRAC authorized wholesale margins. Taxes and dealer markups are applied to this price to determine the final price to consumers.
- **Margin (markup)** - A margin refers to the difference between the selling price and the seller's cost. The term margin is used interchangeably with markup throughout this report.
- **NYMEX** - The New York Mercantile Exchange (NYMEX) is the world's largest physical commodity futures exchange.
- **Retailer** - Any person or company who sells any petroleum product or keeps any petroleum product for sale directly to consumers.
- **Wholesaler** - A person or company that sells petroleum products directly to retailers.



**AUDIT STANDARDS, OBJECTIVES AND SCOPE**

**STANDARDS**

This independent assurance report was prepared by the Office of the Auditor General of Prince Edward Island. Our role is to independently express a conclusion on whether management of IRAC complies in all significant respects with the applicable criteria. The Commission acknowledged responsibility for the subject under audit.

Work conducted for this audit was performed to a reasonable level of assurance in accordance with the Canadian Standards for Assurance Engagements (CSAE) 3001 - Direct Engagements set out by the Chartered Professional Accountants of Canada (CPA Canada) in the CPA Canada Handbook - Assurance.

The Office applies Canadian Standard on Quality Control 1, and accordingly maintains a comprehensive system of quality control, including documented policies and procedures regarding compliance with ethical requirements, professional standards, and applicable legal and regulatory requirements.

In conducting the audit work, we have complied with independence and other ethical requirements of the Rules of Professional Conduct of the Chartered Professional Accountants of Prince Edward Island and the code of conduct of the Office of the Auditor General of Prince Edward Island. Both the Rules of Professional Conduct and the Code are founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality, and professional behaviour.

**OBJECTIVES**

The objective of this audit was to determine whether IRAC follows a reasonable process to set petroleum product prices for consumers and licensees.

We developed a number of criteria to assess whether IRAC had met the objective. These criteria are listed in Appendix B.

Criteria were developed from various sources including relevant legislation, IRAC processes, IRAC issued Orders, and industry practice. Management accepted the relevance and suitability of the criteria used in the audit.

**SCOPE AND APPROACH**

The scope of our audit included analysis and testing of records for the period of April 1, 2016 to March 31, 2018.

Our approach included:

- interviews with Commissioners, management, and staff of IRAC;
- analysis and detailed testing of a sample of pricing decisions;
- interviews with stakeholder associations;
- interviews with staff of regulatory bodies in other Atlantic provinces;
- consultation with subject matter expert;
- review of relevant legislation, policies and reports; and
- review of electronic and paper files.

In performing detailed analysis and testing of controls in the scope period, our focus was on petroleum pricing decisions for regular unleaded gasoline, furnace oil, and diesel. We did not audit propane. We tested the processes involved in 30 separate petroleum pricing decision dates (90 decisions across three products) for the scope period.

It is important to note that our observations and conclusions relate only to the petroleum pricing processes of IRAC. Petroleum prices on PEI are regulated under legislation by IRAC, and we did not assess the merits of any petroleum pricing decision made.

**DATE OF REPORT**

We obtained sufficient and appropriate audit evidence on which to base our conclusions on December 7, 2018, in Charlottetown Prince Edward Island.

AUDIT CRITERIA	
1.	<p>IRAC has a well defined approach to set PEI petroleum product prices.</p> <ul style="list-style-type: none"> <li>• The methodology for setting petroleum product prices is documented.</li> <li>• The methodology for setting petroleum prices is approved by the Commission.</li> <li>• The methodology for setting petroleum prices includes                             <ul style="list-style-type: none"> <li>○ documented criteria for scheduled adjustments;</li> <li>○ documented criteria for unscheduled adjustments;</li> <li>○ requirements for documentation of the impact of the factors considered in the decisions;</li> <li>○ requirements for documented approval of the decisions; and</li> <li>○ communication protocol to inform consumers and licensees of decisions.</li> </ul> </li> </ul>
2.	<p>IRAC’s methodology for setting petroleum product prices complies with relevant legislation.</p> <ul style="list-style-type: none"> <li>• Methodology followed by IRAC for petroleum product prices complies with the:                             <ul style="list-style-type: none"> <li>○ <i>Island Regulatory and Appeals Commission Act</i>; and</li> <li>○ <i>Petroleum Products Act and Regulations</i>.</li> </ul> </li> </ul>
3.	<p>IRAC consistently follows its methodology to set petroleum product prices.</p>
4.	<p>IRAC uses relevant market data (qualitative and quantitative) to set petroleum product prices.</p>
5.	<p>IRAC’s process for receiving and assessing applications for changes to wholesaler and retailer margins is documented and transparent.</p>
6.	<p>IRAC’s methodology to set petroleum product prices is transparent to consumers and licensees.</p> <ul style="list-style-type: none"> <li>• IRAC’s methodology is publicly available; and</li> <li>• All factors considered in each petroleum pricing decision are publicly available.</li> </ul>

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