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WSPA Comments on April 11 SB X1-2 Margin Cap and Penalty Structure Workshop Docket #23-OIIP-01

Additional submitted attachment is included below.

Sophie Ellinghouse
Vice President, General Counsel & Corporate Secretary

April 25, 2024

California Energy Commission
Docket Unit, MS-4
Docket No. 23-OIIP-01
715 P Street
Sacramento, California 95814

Uploaded to Docket

RE: WSPA Comments on SB X1-2 Workshop on Maximum Gross Gasoline Refining Margin and Penalty Structure [Docket #23-OIIP-01]

Thank you for the opportunity to comment on the California Energy Commission's (CEC) April 11, 2024, workshop, the stated purpose of which was "to explore structures for determining a maximum gross gasoline refining margin (max margin) and penalty" per Senate Bill (SB) X1-2 (2023). The Western States Petroleum Association (WSPA) is a non-profit trade association representing companies that import and export, explore, produce, refine, transport and market petroleum, petroleum products, natural gas, and other energy supplies in California. These comments are based on WSPA's review of the materials and statements at the workshop, and we reserve the right to amend these comments or add to the docket as necessary to reflect additional materials or changes in the CEC's decisions.

We are increasingly concerned that a predetermined outcome has already been established[1,2] and encourage the CEC to first complete its due diligence and advance its understanding of the multiple complex factors affecting California's unique transportation fuel supply and pricing issues ***before*** seeking to implement a novel policy that could only exacerbate an already challenging market and lead to higher gas prices for California's consumers. To address today's challenging gasoline price environment, the CEC should instead be pursuing measures to increase local supplies and ease price pressures resulting from a constricted supply.

The CEC must fully evaluate all potential impacts and consequences of adopting a gross gasoline refining margin cap and penalty, whether intended or unintended. The CEC cannot simply hope or speculate that the likely benefits to consumers will outweigh the potential costs. A cap that only further constricts the State's fuel supply capacity will only harm California's consumers, not help them. We have seen this before: California has, in recent memory, advanced novel energy pricing policies, with good intentions, only to face substantial implementation issues – including energy supply shortages that resulted in even ***higher*** prices.

To summarize the main points of this letter:

- California's ongoing market volatility can be directly attributed to chronic (and compounding) supply-side policy obstacles that artificially limits refiners' ability to meet the State's demand;

[1] Indeed, the CEC's initial Request for Information (dated April 26, 2024) stated: "[Can we include an explanation of why a penalty might be needed? I.e. that the state has experienced more frequent price spikes and that those higher prices have boosted profits but those higher prices have not led to increasing imports of supplies that mitigate price spikes? Or include some of the SBX 1-2 language that describes why a penalty is being contemplated?]"
[2] See April 11, 2024, CEC Workshop Event Recording, Vice Chair Siva Gunda, at 00:06:59 mark: "…really move forward on making sure the penalty lands this year…" at: https://www.energy.ca.gov/event/workshop/2024-04/workshop-sb-x1-2-maximum-gross-gasoline-refining-margin-and-penalty

- The CEC and its own consultants have recognized that there is no excess capacity available across California's refining fleet to produce more gasoline to meet California's demand;
- Rushing to impose a first-in-the-nation margin cap and penalty *only upon* California's refiners will likely lead to *less supply* – not more – for the numerous reasons identified; and
- California's refiners would not willingly and knowingly violate State law.

In responding to the information presented and comments made at the April 11 workshop, this letter incorporates by reference our prior comment letters[3,4,5,6,7] on this topic and: (1) further explains why a margin cap and penalty would not address California's ongoing supply imbalance issues; (2) responds to the CEC Division of Petroleum Market Oversight's (DPMO) Chief Economist's workshop presentation; (3) responds to the Stillwater workshop presentation; and (4) responds to the ICF workshop presentation. WSPA would be happy to provide further information necessary to help answer important questions the CEC faces on this policy matter.

A MARGIN CAP AND PENALTY WILL NOT SOLVE CALIFORNIA'S LONG-STANDING SUPPLY PROBLEMS

SB X1-2 ***expressly prohibits*** the CEC from adopting a margin cap and penalty if they will ***potentially hurt*** California's consumers more than ***likely help*** them. The law mandates that the only way the CEC can make a factually complete and informed decision on this threshold finding is by first evaluating actual market evidence and assessing whether a margin cap will likely lead to an even greater imbalance between supply and demand than what we already have today – or lead to even higher prices at the pump. The evidence collected over two decades by third party experts, government oversight agencies, and even the State itself has been clear about the underlying market reasons for California's high gasoline prices: **ongoing market volatility can be traced directly back to chronic (and compounding) obstacles to bringing supply to market despite the sustained, strong demand from California's consumers**.[8]

A margin cap would address none of these foundational issues, and very likely would exacerbate them.

We have previously explained why California – the world's third largest fuel market – is a "fuel island," and the CEC's Draft Transportation Fuels Assessment agrees.[9] California enforces the most stringent gasoline emissions requirements in the nation and, as such, is dependent on domestic refinery production or alternative supplies from global sources that meet these stringent requirements. As the State's own analyses recognize, transportation fuels remain in high demand by California consumers[10] and will remain in high demand for decades to come.[11]

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[3] Western States Petroleum Association Comments - on SB 2 Implementation; May 30, 2023.
[4] Western States Petroleum Association Comments - on Transportation Fuels Assessment Report Workshop; September 11, 2023.
[5] Western States Petroleum Association Comments - Solomon Report California Refiners' Cost and Margin Analysis, 2000-2022; November 27, 2023.
[6] Western States Petroleum Association Comments - literature review on Energy Price Controls; November 27, 2023.
[7] Western States Petroleum Association Comments - on Nov 28 SB X1-2 Margin Cap and Penalty Workshop; December 12, 2023.
[8] *See*, *e.g.*, "Distinct Factors Drive High Gasoline Prices in California: OPIS | Rigzone" (Feb. 22, 2024); "West Coast gasoline prices have been volatile this year - U.S. Energy Information Administration (EIA)" (Dec. 2, 2022); "Petroleum Market Advisory Committee Final Report," Sept. 25, 2017 (found at https://efiling.energy.ca.gov/GetDocument.aspx?tn=221306&DocumentContentId=22709); California Attorney General Bill Lockyer, "Report on Gasoline Pricing in California," May 2000 at: https://oag.ca.gov/sites/all/files/agweb/pdfs/antitrust/gasstudy/gasstudy2.pdf
[9] CEC Draft Transportation Fuels Assessment, published on April 12, 20224, at: https://content.govdelivery.com/accounts/CNRA/bulletins/3961f08
[10] Western States Petroleum Association Comments on Transportation Fuels Assessment Report Workshop filed September 11, 2023 at: https://efiling.energy.ca.gov/GetDocument.aspx?tn=252218&DocumentContentId=87224
[11] See California Air Resources Board's 2022 Scoping Plan Update and CEC's Integrated Energy Policy Reports (linked below).

But State policies specifically designed to ***reduce*** in-State supply and the availability of fossil fuels send a strong signal to companies ***not*** to make the long-term investments necessary to maintain California's current level of refining capacity and production.

And make no mistake – the State's policy choices have already reduced the availability of in-State produced gasoline to California's citizens. As a direct result of California's regulatory policies,[12,13,14,15] Marathon's Martinez refinery and Phillip's Rodeo refinery have stopped producing gasoline, as both have converted to renewable fuel facilities. The CEC notes that, with these two refinery conversions, "statewide gasoline refining capacity decreased by nearly 200 TBD [Thousands of Barrels per Day]."[16] In fact, California is now no longer able to produce all of its own gasoline to meet its own citizens' demand, thereby forcing an increased reliance on importing fuel from outside the State and country. Even the CEC acknowledges that "a strategy to bolster the state's imports of gasoline will be imperative to avoid potentially systemic undersupply problems."[17] In sum, the CEC explicitly recognizes that the refinery conversions to renewable fuels production contributed to a loss of in-State gasoline production, ultimately causing the State to shift to more reliance on marine imports.

We have explained why there is very little supply "help" on the way from outside of California.[18] Most refineries outside of California *cannot produce* fuels that meet California's strict gasoline specifications. For the few refineries that can, getting this fuel to California's market can be challenging; California is neither directly connected by pipeline to domestic refining centers in the Gulf Coast (due to the Rocky Mountains), nor easily able to import foreign sources of gasoline into California (due to the Pacific Ocean). As the CEC has noted, "[m]arine imports generally tend to have higher prices compared to in-state refining, as ships can be expensive to operate compared to pipelines and present different environmental risks."[19] The CEC also acknowledged that "long lead times makes marine imports of refined gasoline less feasible for meeting immediate demand when California refineries experience unplanned reductions in capacity or have other supply shortages."[20] The more product we must import across an ocean – into a State with limited import infrastructure – the more unnecessary costs and transportation emissions are incurred to supply gasoline to California's consumers.

This increasing reliance on gasoline imports exposes California's industry and, by extension, California's consumers, to the uncertainties of a complex global commodities market our members cannot control.

Penalizing California's remaining refiners for providing much-needed gasoline to California consumers will only exacerbate this systemic undersupply issue. As Dr. Matthew Zaragoza-Watkins previously noted,[21] a margin cap would be effective ***only if*** refiners have capacity to increase production. If refiners do not have the capacity to increase production, "then … *prices will still be high* for transportation fuel in California." WSPA emphatically agrees. In fact, the

[12] https://www.gov.ca.gov/2020/09/23/governor-newsom-announces-california-will-phase-out-gasoline-powered-cars-drastically-reduce-demand-for-fossil-fuel-in-californias-fight-against-climate-change/
[13] AB 1279 (2022) at: https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=202120220AB1279
[14] CARB 2022 Scoping Plan Update at: https://ww2.arb.ca.gov/our-work/programs/ab-32-climate-change-scoping-plan/2022-scoping-plan-documents
[15] CEC Draft 2023 Integrated Energy Policy Report at: https://www.energy.ca.gov/data-reports/reports/integrated-energy-policy-report/2023-integrated-energy-policy-report
[16] CEC Draft Transportation Fuels Assessment, published on April 12, 2024.
[17] CEC Draft Transportation Fuels Assessment, published on April 12, 2024.
[18] See WSPA Comments Regarding SB X1-2 Transportation Fuels Assessment Workshop [Docket #23-SB-02], filed Sept. 11, 2023.
[19] CEC Draft Transportation Fuels Assessment, published on April 12, 2024.
[20] CEC Draft Transportation Fuels Assessment, published on April 12, 2024.
[21] See November 28, 2023, SB X1-2 Workshop Event Recording at 50:00 mark (emphasis added) at: https://www.energy.ca.gov/event/workshop/2023-11/sb-x1-2-workshop-maximum-gross-gasoline-refining-margin-and-penalty

CEC has recently acknowledged that refiners usually do not have the capacity to increase production: “Refineries typically operate at their maximum stated capacity when possible.”[22] The CEC’s own expert consultants in this effort agreed as well.[23,24] This inability of refiners to increase production therefore renders a margin cap not only ineffective but costly for Californians.

We have explained how energy price controls have been tried – and failed – before. WSPA commissioned a broad literature review by Catalyst Environmental Solutions that included both the economic and policy impacts of regulatory intervention on fuel prices, both in the oil and gas markets globally and domestically.[25] The literature shows that historic Federal market interventions were ultimately ineffective in lowering consumer prices, and that efforts aimed at capturing “excess profits” actually had the opposite effect: creating artificial supply constraints in the face of strong demand, often (predictably) resulting in higher prices for consumers. The literature demonstrated how such efforts may also decrease future investment,[26] which could result in the further degradation of a reliable supply of gasoline in California.

We have explained why chronic structural fuel supply obstacles create gasoline price volatility. The CEC, through multiple Integrated Energy Policy Reports, also predicted that California would have an increasingly difficult time avoiding market volatility due to the pressures of diminished local supply in the face of continued strong consumer demand. These obstacles remain unaddressed and are only compounded when the State: (1) continues to pursue policies that shrink in-State production of transportation fuels for Californians; (2) simultaneously discourages capital investments in California’s petroleum infrastructure; (3) proposes to increase both the stringency and cost of compliance with existing State programs; (4) seeks to ban the sale of internal combustion engine vehicles even with California’s significant and ongoing electric infrastructure and pricing challenges; and (5) adopts regulations that will make it more difficult to import transportation fuel supplies through California’s ports in the near future. It is hard to imagine how adding a novel margin cap and penalty to this mix would do anything but compound California’s fuel supply and pump price challenges.

We have explained that refining is a challenging, complex, and fluctuating business. The CEC’s own data demonstrates this. WSPA has submitted information from HSB Solomon Associates LLC[27] which demonstrates that California refiners’ margins (gross and net) have eroded since 2000 due to increasing crude prices and increasing operating cost pressures, and that replacing California’s domestic crude with imports contributes to those increasing costs. Yet the CEC continues to discount the operating costs and *net* margins in favor of *gross* margin reporting and publicly available data. It is apparent that now is the time for the CEC to consider how to incentivize the remaining refiners to continue making investments in our gasoline production infrastructure by providing a more certain regulatory environment.

We have explained that the refining industry – like all other major free market industries – is bound by and adheres to strict antitrust laws. Refineries do not “manipulate the market” nor engage in “price fixing.” Decades of real-world research have repeatedly confirmed this.

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[22] CEC Draft Transportation Fuels Assessment, published on April 12, 2024.
[23] See April 11, 2024, CEC Workshop Event Recording, Dave Hackett, upon questioning, at 02:28:12 mark.
[24] See April 11, 2024, CEC Workshop Event Recording, Tom O’Connor, upon questioning at 02:28:41 and 02:28:56 marks.
[25] “Western States Petroleum Association Comments - literature review on Energy Price Controls;” November 27, 2023: https://efiling.energy.ca.gov/GetDocument.aspx?tn=253336&DocumentContentId=88551
[26] See Catalyst report at Brown, M., Rewey, C., & Gagliano, T. (2003). Findings on Hawaii Gasoline Prices and Policies. Honolulu: NCSL Energy Program. Accessed Oct. 2023, https://energy.hawaii.gov/wpcontent/uploads/2011/10/HIGasPricesPolicies_2003.pdf
[27] Western States Petroleum Association Comments – Solomon Report: California Refiners’ Cost and Margin Analysis, 2000-2002; November 27, 2023 at https://efiling.energy.ca.gov/GetDocument.aspx?tn=253316&DocumentContentId=88543

California's gasoline industry is amongst the most highly scrutinized and regulated industries in the world and has been subject to multiple investigations by different State Attorneys General. And the results of this fact-finding are clear: no evidence of price fixing or any anticompetitive conduct by refiners has ever been found. Even the CEC, after studying this issue for months, found in October 2019 that, while refiner margins had some "short term" spikes, due primarily to refinery outages (*e.g.*, the 2015 Torrance outage), refiner margins "do not account for the sustained price elevation seen over the past five years." The CEC therefore "rul[ed] out refinery price margins as the cause of the residual price increase."[28]

In addition, our refiners would not willingly and knowingly violate the law. Refiners may determine that, to avoid revenues from exceeding a margin cap and causing potential violations, they would be required to ramp down production. If refiners respond in this way, in-State fuel supplies would be reduced further – which, in the face of sustained strong fuel demand from California's consumers – is an economic recipe to create higher prices at the pump. This would hurt, not help, Californians.

The CEC surely must recognize this. If it does not, we advise the CEC to meet individually with every in-State refinery operator under the protections afforded by the Petroleum Industry Information Reporting Act of 1980 and ask them: Would they continue running their refinery at the same rate if doing so would violate a margin cap imposed by the State of California?

WSPA RESPONSE TO PRESENTATION BY DPMO CHIEF ECONOMIST DR. MORENO

Comments by both Drs. Moreno and Zaragoza-Watkins seem to rely on the ill-founded notion that California refiners are somehow choosing to operate below capacity for the purpose of constraining supply, raising prices, and driving higher profits. They further argue that by imposing a penalty, refiners will then respond by raising outputs. What both economists fail to realize is that refiners seek to run at maximum capacity to meet demand. Capacity only becomes underutilized as a result of either unplanned interruptions or planned maintenance, two modes of operation refiners prefer to minimize as much as possible. As a result, refiners seek to mitigate lost capacity (and therefore, lost earnings) by performing preventive maintenance in the most efficient way possible and to prevent unplanned outages. Simply put, refiners ***lose*** money when their facility's capacity is diminished by maintenance or unplanned interruptions. And we must repeat here the remark by Dr. Zaragoza-Watkins[29] that if in-State excess capacity is not available, higher prices will persist to incentivize additional supplies from outside the State, which bring with them higher transportation emissions and greater expense in getting that fuel to California's market.

WSPA emphasizes that petroleum refineries cannot safely be pushed beyond their capacity – even when presented with the opportunity of reaping higher prices. Pushing a refinery beyond its capacity to "just produc[e] a little bit more"[30] threatens to compromise that refinery's maximum safe level of operation and would likely result in the very types of unplanned maintenance events that can lead to supply constraints and gasoline price spikes – something that the CEC wants to avoid. WSPA's refining members share this desire to avoid increasing unplanned maintenance events.

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[28] Additional Analysis on Gasoline Prices in California, CEC, October 2019 (emphasis added) https://www.energy.ca.gov/sites/default/files/2019-11/Gas_Price_Report.pdf
[29] See CEC November 28, 2023, Workshop Event Recording at 50:00 mark at: https://www.energy.ca.gov/event/workshop/2023-11/sb-x1-2-workshop-maximum-gross-gasoline-refining-margin-and-penalty
[30] See April 11, 2024, CEC Workshop Event Recording at 49:40 mark.

We also recognize the State's intention to transition to lower carbon energy sources. However, California must also acknowledge this will be a decades-long transition, and constraining in-State gasoline supply does not magically accelerate this transition; it only punishes Californians who rely on those fuels every day. Rather, along with investments in lower carbon sources, the State should encourage more private sector-led investments into new crude and gasoline production in order to decrease the risk of supply shortfalls that lead to short-term gasoline price volatility. Instead, as we have explained, California increasingly and deliberately constrains in-State-produced gasoline supply in the face of robust consumer demand. This is the type of economic paradigm that easily lends itself to the very types of problems we see today. We would urge the CEC to reject the invitation to deliver a hollow political victory while doing nothing to address the underlying issues for the rest of California's citizens. Imposing a margin cap instead of fixing supply-side issues is a recipe for disaster.

A margin cap would not increase in-State supply; indeed, it is likely to have the opposite effect. What would increase supply is promoting policies that ***actually increase in-State gasoline supply***. Supporting local, in-State production would be a great step towards increasing and then stabilizing our gasoline supply.

In terms of the penalty scheme being considered by the CEC, WSPA previously noted how a penalty structure would be unworkable in practice, and urged[31] the CEC to consider fundamental fuels market issues, including: (1) how a gross refining margin cap would impact petroleum cost or statewide supply; (2) what precedent the CEC would set as a government entity attempting to determine the "allowable" income for California businesses; (3) why the State government should determine the "appropriate" profit (or loss) for privately-owned companies in just one industry singled out by the government; (4) what specific factors the CEC would consider in even attempting to set such a level; (5) how to determine what percentage of a refiner's income it would be required to pay to the State; and (6) what financial support the CEC would offer to facilities operating at a loss (as California has already done for the electric industry with respect to power plants). There are few easy answers to these questions, and no evidence that any penalty scheme proposed by the CEC would reduce price volatility and actually help California consumers rather than hurt them.

To specifically address Dr. Moreno's proposal, WSPA offers the following comments:

- **Excess Capacity Assumption.** Dr. Moreno incorrectly assumes that there is excess California refinery capacity. She further assumes that this excess capacity is a result of California refiners somehow limiting production to achieve an artificially high price (despite, as noted above and below, that there is no evidence that refiners are actually limiting production in an attempt to influence prices, and that the State has incentivized the conversion of two in-State refineries away from gasoline refining). Based on these incorrect assumptions, she wrongly argues that the margin cap will incentivize refiners to increase gasoline production, thereby lowering gasoline prices.
    1) Importantly, Dr. Moreno acknowledges the inevitable market implications of her assumptions being incorrect: "If the industry does not have capacity…there is no way that industry can respond by increasing output. Then you do have a situation where the policy looks more like a price cap within the refining sector…If there is no capacity, what's going to happen is that you could potentially increase price at the retail end of the market."[32]

[31] Western States Petroleum Association Comments – WSPA Comments on SB 2 Implementation filed May 30, 2023, at https://efiling.energy.ca.gov/GetDocument.aspx?tn=250404&DocumentContentId=85146
[32] See April 11, 2024, CEC Workshop Event Recording at 57:01-58:00 mark.

2) The critical question therefore becomes: Is there actually capacity for California's gasoline producers to increase production? As discussed above, even the CEC has acknowledged that refineries have already been incentivized to utilize all possible excess capacity in order to maximize production. As discussed below, both Mr. O'Connor and Mr. Hackett also agree that there is no capacity to substantially increase in-State refining production.[33]
3) This lack of excess capacity results in two important points: (a) Dr. Moreno's assumption that the margin cap will incentivize increased production is incorrect, and (b) where there is no capacity to increase production, a margin cap will, in fact, have the effect of reducing output at the wholesale level, resulting in increased price pressure at the retail level. Dr. Moreno even concedes this latter point.
4) The industry has historically maintained a delicate supply/demand balance within the State. Indeed, 90% of California's gasoline consumption is produced in-State; though domestic crude supply, one of the major cost components, is limited and must be sourced from out-of-State, subject to global markets. The remaining 10% of California's gasoline is imported. Factors such as rising demand or operational upsets can upset these supply/demand balances. When the market is short (*i.e.*, characterized by low supply), an economic signal needs to occur and be sustained long enough to encourage supplies to flow in from other markets. Out-of-State refiners also need to tune their operations, and overseas transportation needs to be secured for voyage times that can take weeks (*i.e.*, from Asian markets, this can take 30-45 days). Upon arrival, docks in the California market can also be constrained, further delaying resupply to the market. California's resupply options are often limited to the costliest modes of fuel transportation, *i.e.*, marine vessels, which are exposed to the uncertainties of weather and global geopolitical events. Conversely, when supply exceeds demand, inventories will rise.
5) We must not confuse total profit and loss with marginal economics. In periods of shortage, prices must rise to attract additional supplies from offshore, often from foreign markets. These higher prices can set the overall market pricing.
6) Finally, the CEC should take note that the California Air Resources Board's (CARB) recent amendments to the Ocean-Going Vessels At-Berth Regulation (At-Berth Regulation) will serve to *further* constrain gasoline and crude supply into California. By requiring petroleum tankers to use emissions capture or shore power technology not yet developed, tested, or implemented on the vast majority of California's tanker fleet or tanker terminals, CARB's At-Berth Regulation will force many tankers to reduce visits to California ports starting in 2025 to meet the At-Berth Regulation's requirements. This is another example of a State policy that will further restrict the availability of gasoline in the State of California, and will limit the State's ability to mitigate in-State shortages of gasoline supply with marine imports. And it is another policy that will likely hurt California consumers rather than helping them.

- **Use of Gross Margins.** Dr. Moreno stated that "in the real world, we rely on accounting concepts of profitability, such as gross margins."[34] WSPA has previously explained why it would be unfair to assess any penalty on gross margins, including that:
  1) Gross margins, as defined by the CEC, dramatically understates costs of goods sold and exclude operational costs altogether, which means that even if the CEC allows refiners to make a positive ***gross*** margin, it could still be imposing a negative ***net*** margin – *i.e.*, forcing refiners to operate at a loss, at least for parts of the year. This could, in turn,

[33] See April 11, 2024, CEC Workshop Event Recording at 2:28-2:30 mark.
[34] See April 11, 2024, CEC Workshop Event Recording at 44:58 mark.

force refiners to choose between producing gasoline at a loss or exiting the market altogether.

2) A "gross gasoline refining margin" concept does not actually exist, as it improperly focuses on one product, but that is not how refineries operate or report data (*i.e.*, refineries purchase and produce ***slates*** of products).
3) Imposing a penalty based upon a gross margin would force refiners to engage in a high-stakes guessing game; *i.e.*, refiners would be forced to try to adjust their prices in real time so that their monthly ***gross*** refining margins would hopefully remain below any maximum cap imposed by the CEC – something they would, of course, not know until after the fact. The timing of crude purchases, operational performance, and market supply/demand dynamics make it very difficult to accurately estimate margins on a daily or monthly basis. This, again, forces refiners to choose. They can try to adjust their prices to bring their margins below the maximum – but risk violating any CEC-imposed cap if they estimate wrong about the future of wholesale prices or acquisition costs. Or, where contract formulas are not pre-established, they can set prices so far below what is required to comply with any maximum margin that it would no longer make economic sense to refine in California. Either option would jeopardize California's transportation fuels markets and give rise to serious constitutional and other legal concerns related to the arbitrary penalization of refiners without any connection to the benefits the State Legislature intended through enacting SB X1-2.
4) Imposing a gross margin would run counter to meeting the ongoing demand of Californians – especially given California's already-volatile fuels market. If another refiner decides to leave the State, there is no guarantee that another company will be willing to take its place.

- **Excess Margin.** Dr. Moreno argues that California's refiners earn excess margins: *i.e.*, margins that exceed some arbitrary and subjective "reasonable" benchmark. But no benchmarks proposed to date fairly and accurately represent the California transportation fuels market.
  1) **Comparison with Baseline Year(s).** Dr. Moreno identified 2012 through 2014 as a period establishing a "reasonable benchmark." However, as noted above, California had 200 TBD more capacity in 2012-2014 than it does currently (*i.e.*, roughly 20% more capacity).[35] With the conversion of the Rodeo refinery in March 2024, California can no longer adequately supply its own gasoline and must now increasingly rely on costly imports. Such a comparison must also account for the increased cost of doing business in California over that time span. A simple inflation adjustment would be inadequate, because the cost of doing business in California has outpaced inflation. The increased costs of operating a refinery in California must all be accounted for as well.
     a. Before Dr. Moreno's presentation, the CEC staff displayed a historical "Refiner Margin" chart, which was defined as rack price minus crude oil cost and imported refined gasoline minus environmental costs. If Dr. Moreno is using that definition, then it excludes operating costs, capital investments, overhead allocation, etc., which would be an inappropriate benchmark for assessing whether refiners are making "too much" profit.
  2) **Comparison with Other Geographic Locations.** Dr. Moreno included Dr. Severin Borenstein's "Mystery Gas Surcharge" graph in her presentation and suggested a geographic benchmark could also be used to measure "excess" margins. However, this approach suffers from the same shortcomings as using the 2012-2014 period to "benchmark" a profit baseline: the "US (ex-CA)" benchmark is not properly

[35] CEC Draft Transportation Fuels Assessment, published on April 12, 2024.

representative of baseline conditions in the *California market*. There are important market considerations when comparing California with other geographic locations that must be understood and accounted for before arriving at such a benchmark:

a. If the CEC is going to reference a different geographical area in determining a benchmark, it would be more appropriate to compare gasoline prices in California to prices in "PADD 5 West Coast (ex-CA)" because both markets are isolated markets and both markets have experienced an increasingly tight supply of petroleum products and declining refinery capacity.
b. Because we are often asked what makes the Gulf Coast different from the West Coast, please refer to the following:
    - Gulf Coast refiners produce gasoline in accordance with U.S. Environmental Protection Agency (EPA) standards, which protect both environmental and consumer safety. These refiners can produce EPA-compliant gasoline more efficiently and more cheaply without having to comply with California's regulations required for CARBOB production. Additionally, this EPA-compliant gasoline is easier to produce, easier to transport by pipeline to the rest of the United States, and has the major advantage of being fungible across a much larger market.
    - The West Coast refineries represent 13% of U.S. refining runs while having 16% of gasoline demand, whereas, the Gulf Coast has 55% of refining capacity with 15% of U.S. gasoline demand.
    - The Gulf Coast has incentivized and enabled significant capital investments in its energy infrastructure, enabling increased crude production and refining capacity, whereas California has disincentivized and continues to discourage such investments. This lack of infrastructure (*e.g.*, dock space) leads to liquidity issues when there is a supply disruption, which is also a key factor in California price spikes.
    - The Gulf Coast markets are also home to more producing, midstream, refining, marketing, and retail companies compared to California, which enables increased competition and efficient, flexible markets to supply the lowest-cost gasoline to its consumers. In comparison, California has imposed burdensome and complex legislation that has made operating current businesses and investing in new businesses difficult for new entrants and market participants, stifling further competition and causing unintended consequences that could further eliminate existing businesses. Decades of policies explicitly targeting the hydrocarbon industry have brought California to where it is today, as it has devalued energy security and made it more difficult for Californians to affordably access a reliable in-State supply of transportation fuel.
    - In addition, the CEC must consider the continued motivation for investment into California's gasoline production infrastructure. There is an investment dilemma that oil companies have when reviewing the "crack spread," *i.e.*, the difference between the purchase price of crude oil and the selling price of finished products. Crack spread is a metric used by energy market experts to help monitor gross refining margin potential, from the West Coast versus the Gulf Coast. Since 2020, with the 5-3-2 crack spread comparison between these coasts, there is no longer a West Coast premium. This shows it is even more important for California to help define a more certain regulatory environment to be more competitive as a place to do business, as investors are looking to safeguard investments from risk. See **Appendix A**.

  - From 2000–2022, US (ex-CA) invested in refining capacity (with the Gulf Coast's capacity increasing 27%). In contrast, California's refining capacity declined 12%.[36]
  - Further, the Gulf Coast is interconnected and is not a gasoline island like California is.

- **Turnarounds Require Detailed Planning.** Refineries develop turnarounds premised upon considerations including operational capability, regulatory compliance, asset integrity, reliability, and risk management several years beforehand. Typically, detailed work planning, engineering, and procurement begins years before the event to ensure sound execution and to develop staffing plans. To further demonstrate that safety and operational sustainability are of the utmost importance, refiners incentivize their work force to ensure minimal downtime by implementing a bonus structure that is tied to mechanical availability and safe operations. As refiners face real constraints and strive to maximize their operable capacity, refinery utilization reductions usually occur due to either planned or unplanned events.
  1) In a competitive marketplace with limited materials and skilled contract labor, operators must proactively secure resources many months, and in some cases years, in advance. Turnaround contractors are informed of planned work scopes at least a year ahead of the outage, enabling them to obtain competent leadership and skilled workers to efficiently execute complex tasks within a short timeframe, thereby allowing refineries to resume normal operations promptly. Additionally, arrangements for blend stocks or products must be made in advance, or alternative supplies must be planned to ensure uninterrupted operation of dependent process units during planned maintenance. Refineries collaborate with contract companies, vendors, and trading partners to secure necessary supplies. There are critical differences between each refinery and distribution systems, as well as safety considerations, that also drive the planning of maintenance. Allegations suggesting coordination with other operators to manipulate the market are baseless and unfounded.
  2) Given that unplanned events pose substantial risks to process unit equipment, personnel, and the environment, operators endeavor to minimize such occurrences. Operators prioritize reliability aimed at maximizing the availability of operating process units. Proactive reliability programs include operator care, quality control processes, preventive maintenance programs (ex. vibration monitoring, visual inspections, lube oil changes), and careful selection of the right turnaround work scope and interval. Operators are incentivized to minimize unplanned downtime as this reduces repair costs, emissions, and maximizes production.
- **Need to Stabilize Gasoline Supplies.** Inherent in the passage of SB X1-2, the State Legislature sent a clear message through the rejection of the Governor's first legislative proposals (*i.e.*, to immediately impose a "windfall profits" penalty) in favor of a more thoughtful approach: *i.e.*, that the CEC *first* gather real-world evidence on whether a cap on refinery margins could have unintended consequences that would harm California consumers. The law explicitly requires that the CEC "***shall not*** set a maximum gross gasoline refining margin or accompanying penalty . . . ***unless*** it finds that the likely benefits to consumers outweigh the potential costs," considering factors such as whether action would lead to a greater supply and demand imbalance in California's fuels market or lead to higher pump prices."[37] As such, the Legislature's expectation of the CEC is clear: evaluate the facts, not the politics, in promoting solutions that benefit Californians rather than hurting

[36] See https://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=8_NA_8D0_SCA_4&f=A (California) and https://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=8_NA_8D0_R30_4&f=A (PADD 3 (Gulf Coast)).
[37] PRC Section 25355.5(l) (emphasis added).

them. The Commission has historically been the State's energy planning entity, and given the vast quantities of data now being collected about the petroleum sector, the CEC should refocus on its original mission of evaluating how best to ensure stable energy supplies in the State – including for gasoline.

In sum, implementing a margin cap will not solve California's supply issues or change market behaviors. Allowing periodic adjustment of such a maximum margin would not improve things, but would only introduce an element of uncertainty which could severely discourage capital investment and exacerbate future supply issues. As previously mentioned, investment decisions are driven by a reasonable expectation of future profits. Instead, we urge the Commission to take a proactive approach to finally resolving the State's long-standing supply issues. By working with in-State refiners and supporting them through the development of reliable infrastructure, the CEC can help increase production of transportation fuels to meet California's increasing fuel demands, thereby attacking the root causes of market volatility and benefitting California consumers over the long run.

WSPA RESPONSE TO PRESENTATION BY STILLWATER'S DAVE HACKETT

WSPA appreciates Mr. Hackett's efforts to present a real-world analysis of the impact of a cap on gross refining margins. In this and in past presentations, Mr. Hackett has described for the CEC the complexity of the refining industry and the broader gasoline supply chain, including the impact that public policy has had. While some of his comments about refiner responses to a gross margin cap were speculative and do not necessarily reflect actual refiner intent, we support his assessment of the potential market impacts a cap could have. We also agree with his statements that he "do[es]n't think there's spare capacity to increase production"[38] and that he believes that in-State refineries are "running as hard as they can."[39]

The Margin Cap Does Not Solve California's Undersupply Problem. Mr. Hackett stated, "I don't see anything within this program that would increase supply…Fundamentally this [program] doesn't improve logistics, it doesn't increase refining capacity, it doesn't provide incentives for investment."[40] He continued, "Here we are in 2024 and we are down two refineries, and so the going forward here is going to be rougher than it's been. I think that the market is short on the order of 15% of supply. Some of that comes from the refineries in the Pacific Northwest [via marine shipments], and the balance will come from around the world." WSPA agrees.[41]

The Margin Cap Will Exacerbate Elevated Prices. Mr. Hackett also stated, "[If] the program is implemented…refiners would probably leave prices up close to the maximum level…we come to this conclusion from our experience in Hawaii…The government set a maximum gasoline price and refiners moved their prices to as close to the maximum as they could get them." [42] He continued, analyzing his graph, "what this illustrates is that consumers might… be worse off with a maximum gasoline margin…"[43] While WPSA does not agree with the exact mechanism of consumer harm as outlined by Mr. Hackett, WPSA agrees that the margin cap will likely ultimately increase retail prices (as Dr. Moreno, in fact, acknowledged as a possibility). WSPA

[38] See April 11, 2024, CEC Workshop Event Recording, Dave Hackett, upon questioning, at 02:28:00 mark.
[39] See April 11, 2024, CEC Workshop Event Recording, Dave Hackett, upon questioning, at 02:28:12 mark.
[40] See April 11, 2024, CEC Workshop Event Recording, Dave Hackett, Stillwater Presentation at 2:10 mark.
[41] See April 11, 2024, CEC Workshop Event Recording, Dave Hackett, Stillwater Presentation at 2:23 mark.
[42] See April 11, 2024, CEC Workshop Event Recording, Dave Hackett, Stillwater Presentation at 1:29-1:30 mark.
[43] See April 11, 2024, CEC Workshop Event Recording, Dave Hackett, Stillwater Presentation at 1:33 mark.

also agrees that price volatility is inevitable in periods of tight supply, and that a permanent solution to price volatility requires a permanent solution to the underlying supply issues.

To address Stillwater's presentation, WSPA offers the following specific comments:

- **Business Profitability.** Mr. Hackett claimed during his presentation that gross margin calculations are commonly used to approximate business profitability – though it is not a comprehensive picture of refiner profitability. In fact, **gross margin calculations are not commonly used to approximate business profitability**. As discussed above, crack spreads are.
- **Flaws with GGRM.** Mr. Hackett also acknowledged that the Gross Gasoline Refining Margin is a flawed measure. He estimated that an average of 63 cents separated the highest from the lowest historical margins among refiners and stated that this metric is not a "complete picture" of profitability. He also suggested that a penalty based on this measure could have the opposite of its intended effect by increasing average prices.
- **Market Manipulation.** Mr. Hackett further claimed that trading patterns suggested the possibility of market manipulation. This claim is unfounded. Mr. Hackett pointed to litigation regarding trading activity after the 2015 Torrance refinery explosion as "evidence" of this claim. But no refiner was named as a defendant in this litigation, which addressed only a scattered handful of trades and which has since been resolved with no finding of wrongdoing by the court.[44] And while another group of plaintiffs did sue refiners claiming that refiners manipulated spot prices, they found no evidence to support their claim after extensive discovery, resulting in summary judgment against the plaintiffs.[45] In short, no court or regulator has, in recent memory, identified any evidence of market manipulation by refiners, despite the gasoline industry being among the most closely scrutinized in the world. WSPA strenuously objects to the suggestion that refiners engage in anticompetitive activity, let alone that this activity is systemic.
- **Refiners' Short-Term Options.** Mr. Hackett suggested that refiners may consider numerous short-term options to avoid the penalty (*e.g.*, closely managing rack gasoline prices, generating other opportunities to improve margins under the cap like adding fee-based revenue generators, buying crude at higher prices from affiliates or blend in other components or lease a refinery tank from an affiliate; or establishing a buy-sell agreement with another company on purchased gasoline). While not specifically addressing Mr. Hackett's suggestion, we have articulated our views herein on the actions our members could be forced to take if they are penalized for their profits.

WSPA RESPONSE TO PRESENTATION BY ICF'S TOM O'CONNOR

Mr. O'Connor presented a profit-sharing concept while also recognizing that (1) a "gross margin" does not present a complete view of refinery profits as it does not include operating costs, impacts from refinery performance issues, or the value of other products produced; (2) applying a singular "gross margin" would result in significant variations (especially among California's refiners versus non-California refiners and other wholesale-only purchasers); (3) it is impossible for refiners to allocate expenses to just one product; and (4) this mechanism will not create more fuel supply for California (especially given recent refinery conversions). In addition, during

[44] Joint Stipulation and Order to Stay Proceeding, *California v. Vitol Inc.*, Case No. CGC-20584456 (S.F. Super Ct. filed May 4, 2020).
[45] *Persian Gulf Inc., v. BP West Coast Products*, 15-cv-1749-JO-AGS, Dkt. 847 (S.D. Cal. Sept. 30, 2022).

questioning, Mr. O'Connor agreed with Mr. Hackett that California's "refiners are running as hard as they can"[46] and "trying as hard as they can"[47] to meet California's demand.

To address ICF's presentation and proposal, WSPA offers the following specific comments:

- **The Margin Cap Does Not Solve California's Undersupply Problem.** Mr. O'Connor stated, "I do not believe that this mechanism is going to create more fuel for California…it's going to take more than one regulatory action to kind of harness the [energy] transition that we're going to be going through over the next few years."[48] Similar to Mr. Hackett, he also notes how significant the undersupply has become: "The closure of the Marathon Martinez refinery in late 2020 results in a much tighter gasoline market in California, particularly as demand increased in the 2021 post-COVID recovery period. In other words, the game has changed. We're not in 2013 anymore, or even 2015. There's less production. Refiners, in order to meet their sales demands, you know, have to import more, and that's more expensive. So, the Rodeo refinery closure in March [of 2024] is going to tighten the market in Northern California significantly further."[49] WSPA agrees with Mr. O'Connor that the margin cap does not solve California's undersupply problem.
- **Mr. O'Connor Acknowledges that He Does Not Know the Effects of His Proposed Variation of the Margin Cap on Price and Quantity.** Mr. O'Connor stated, "Obviously, refiners are going to find ways to try to maximize their profits under this regulatory structure and we're not quite sure how they may do it…I don't know whether this strategy that we proposed here is something that would possibly endure the incentive for them to continue producing fuel and not try to shrink…or export fuel."[50]
- **Flaws with GGRM:** Like Mr. Hackett, Mr. O'Connor pointed out a number of flaws with the Gross Gasoline Refining Margin. First, it ignores operating costs, which he noted are higher in California than elsewhere (in WSPA's view, because of burdensome regulations that make production more costly). Second, it ignores seasonal variations in gasoline margins, which can vary by more than 20 cents between winter and summer. Third, because refiners have different "sales mixes" and distribution channels, applying one margin to all can create an "unfair situation." WSPA agrees that these factors pose a serious challenge to any CEC effort to implement a maximum margin.
- **Rolling Average Benchmark.** Mr. O'Connor suggested that a refinery-specific profit-sharing concept would use an individual refiner's history to develop a routinely updated, 10-year rolling average benchmark.
  1) While this approach does appear to address concerns that the current gross margin calculation is not a comparable data point for each refiner, there are significant concerns with choosing an appropriate benchmark as the market has significantly changed since 2020. A benchmark would have to be adjusted for changes to a refiner's business strategy (refinery rationalization), inflation, and other costs such as investments to improve reliability or environmental emission reductions. This benchmark has potential to unwittingly give certain refiners an advantage.
  2) Even when tailored to better fit individual refineries, this model would still be dependent on the flawed definition of Gross Gasoline Refining Margin dictated by SB X1-2.
- **Disproportionate Application.** Mr. O'Connor suggested that this concept does not place a ceiling on the market while still providing an incentive to run the refineries. The downside is that a profit cap and penalty still only impact refineries – wholesale purchasers do not suffer

[46] See April 11, 2024, CEC Workshop Event Recording, Tom O'Connor, during questioning at 02:28:41 mark.
[47] See April 11, 2024, CEC Workshop Event Recording, Tom O'Connor, during questioning at 02:28:56 mark.
[48] See April 11, 2024, CEC Workshop Event Recording, Tom O'Connor, ICF Presentation at 2:02 mark.
[49] See April 11, 2024, CEC Workshop Event Recording, Tom O'Connor, ICF Presentation at 1:43-1:44 mark.
[50] See April 11, 2024, CEC Workshop Event Recording, Tom O'Connor, ICF Presentation at 2:01 mark.

any penalties if their profits rise while refineries' profits are capped. He speculated that the "rocket/feather effect" (*i.e.*, the phenomenon of gasoline prices rising like rockets and falling like feathers) may become more pronounced and needs to be studied separately, and he believes that because refiners will find ways to maximize their profits, a cap and penalty would not necessarily create an incentive to produce fuel rather than shrinking the market or exporting fuel.

CONCLUSION

WSPA appreciates the opportunity to provide our comments on these issues of critical importance not only to us, but to all California citizens who rely on affordable and reliable sources of transportation fuel every single day. The overwhelming evidence gathered by the CEC and other independent researchers over the past few decades demonstrates that market forces, and not illegal market manipulation, have been and continue to be responsible for chronic pressures on fuels supply and market prices. This is not an "industry" conclusion. This is the conclusion drawn by reputable independent and government-sponsored studies we have seen looking at California gasoline market price volatility over nearly the past quarter-century.

Not surprisingly, no participants at the recent workshop could articulate a viable economic rationale for how a margin cap and penalty would help consumers in a supply-constrained market, and indeed, the outside economists who presented to the CEC opined that a cap was a flawed measure that could actually *harm* consumers. Even the CEC's own economist said that a penalty could "potentially increase price at the retail end of the market," and DPMO's own analysis of options for reforming the spot market contained no evidence or allegation of market manipulation by the refining industry. WSPA continues to urge the CEC to prioritize facts over politics and reject a cap and penalty that will only hurt California's consumers rather than help them.

Thank you for considering our comments. Please do not hesitate to contact me with any additional questions.

Sincerely,

Sophie Ellinghouse
Vice President, General Counsel & Corporate Secretary

Appendix A

Calculated 5-3-2 Crack Spreads
West Coast vs. Gulf Coast