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Consumer Watchdog - Strong Penalty Is Only Way to Control Price Spikes

Additional submitted attachment is included below.



May 3, 2024

California Energy Commission
Docket Unit, MS-4
Re: Docket No. 23-OIIP-01
715 P Street
Sacramento, CA 95814-5512

Re: Strong Penalty Is Only Way to Control Price Spikes
23-OIIP-01: RFI Maximum Gross Refining Margin and Penalty

Commissioners,

The following are comments submitted on behalf of Consumer Watchdog in response to your request for information.

1)Should a maximum margin be set and a penalty established? Include a discussion of the pros and cons to consumers of establishing a maximum margin and enforcing a penalty.

Five oil refiners control 98% of the gasoline supply in California and this oligopoly has abused its market powers at times to keep gasoline prices artificially high to its great financial benefit.

Research verified by the California Energy Commission (CEC) and Division of Market Oversight (DMO) shows that with every price spike during the last decade there has been a corresponding margin/profit spike. The price spikes have become more extreme in the last two years, creating an unprecedented \$2.60 per gallon gap with US gasoline prices in October 2022, corresponding with unprecedented refining margins.

The companies have used their consolidated power to pump up their margins to unprecedented levels, as demonstrated by the M1322 data analyzed by CEC. Volume adjusted margins reported under SB 1322 averaged \$1.01 during 2023. By every measure, the refining margins were unprecedented during 2022 and 2023 and these margins corresponded to an ever-widening gap with US gasoline prices.

The price spikes and corresponding profit spikes were typically precipitated by or coincided with a perceived shortage in supply due to a refinery shutdown/slowdown, limited inventory, and/or increased exports, or a spot market trade indicating a coming shortage.

The only way to discourage higher prices and the corresponding higher margins is with the deterrent of a maximum gross refining margin set high enough for a reasonable profit and low enough to discourage the price gouging Californians have been experiencing.

If refiners cannot make unlimited amounts off short supply, they will have an incentive to have ample supply and make more money by making more gasoline. This statement is validated by the economic research of the Division of Market Oversight chief economist Gigi Moreno and Mathew Zaragosa-Watkins of Vanderbilt University and UC Davis, as presented to this Commission.

This is particularly true if the max margin is accompanied by a rule requiring refineries to have adequate inventories when going into a maintenance period, as suggested by the Division of Market Oversight. The Energy Commission already has authority to prevent maintenance that could dry up inventories.

Refining capacity does exist to meet demand in California despite the protestations of the industry, both at existing refineries and to supplement supply in the form of imports of finished product and blend stocks. According to McCullough Research, the Pacific Rim has about 54,785,000 barrels/day of gasoline capacity, which dwarfs the approximately 4.6% that is in Alaska, Washington, and California^{1 2}. Traditionally, when supplies are low, California has imported gasoline for California markets and continue to have the ability to import from other Pacific Rim countries. Ocean shipping from Singapore, for example, is three weeks³. As rational actors, refiners will make use of their ability to import if necessary.

A maximum margin by its very nature will discourage price spikes and the egregious profit taking that comes with them because excess profits will be penalized. The biggest impact of the max margin will be on low-income individuals who cannot afford an extra \$20 per fill up. When gas prices spike, low-income workers feel it the most. At \$4 per gallon, 9% of an annual minimum wage salary is spent on gas. At \$5 per gallon, 11% of an annual minimum wage salary is spent on gas. At \$6 per gallon, 13% of an annual minimum wage salary is spent on gas. Low income individuals and families are the principled beneficiaries of a maximum margin because of its potential to reduce price spikes that are a huge shock to their fragile budgets and stabilize prices.

The con of a max margin comes in only if you believe refiners will collude to game the system to maintain higher levels of profitability all year in order to make up for the lost profit peaks that come with reduced price spikes.

¹ US Energy Information Administration, Capacity of Operable Petroleum Refineries by State 2023, <https://www.eia.gov/petroleum/refinerycapacity/table3.pdf>

² Energy Institute, Statistical Review of World Energy 2023, page 26

³ Ocean shipping from Singapore to Los Angeles, CA: 7669 nautical miles at 14 knots takes 22 days 20 hours. <https://sea-distances.org/>

I find Stillwater's presentation on this point not very compelling. On the one hand, Dave Hackett maintains the market is competitive. On the other hand, he claims if profits are capped, companies will adopt parallel tactics to raise prices all year long to compensate for the lost revenue from price spike profit-taking.

There is a big bar to stop refiners from gaming the system and maintaining higher profits all year long: the law. It is against the law to collude to maintain higher prices in an environment that doesn't warrant them when the market is as consolidated as California's refining market.

Executives know this, which is why price spikes and profits spikes only follow from times of supply disruption or the perception of supply disruption based on spot market transactions, which are the alleged impetus for the higher prices.

In fact, executives for the refining companies have routinely discussed how it is only in troubled markets that they can have such extreme profit taking.

"What we've typically seen in California is when there's operating upsets and supply is impacted, then you see an increase in margins and the financials look respectable. But when everything is running well, it's more challenged," is how Phillips 66 CFO Kevin Mitchell [put it on the company's investor call](#) for the 4 quarter and year end results for 2023 on January 31, 2024.

Tom Nimbley, PBF's CEO, [said on July 29th, 2016](#) following the recovery from Torrance, "there's too much clean product and the only way you can solve that problem is reducing the amount of clean product that you make."

Flattening the profits that refiners can make from price spikes resulting from supply disruptions will discourage those supply disruptions. If the new rules of the game are that refiners can only make more money by having adequate supply they will then have adequate supply. To wit the statement of Valero COO Gary Simmons on the latest [earnings call](#) on April 24, 2024.

Analyst Jason Gabelman of TD Cowen asked about West Coast.

"I wanted to get a sense of what you are you seeing on the West Coast as we move into the summer now that another asset will be permanently shut down there. Are you seeing ratable exports coming from overseas product-wise into that market or do you expect heightened volatility and elevator prices there?"

Gary Simmons, COO: 37 mins

"In the first quarter, we saw a little lower demand at least in our system in California for gasoline, which I think was related to weather. We've seen demand kinda return to normal patterns. It's very difficult to just speculate and put barrels on the water to import into the

California market. We don't think a lot of people are doing that and you need to see the market react before you would go ahead and put barrels on the water for import into California. So, there will be a lot of volatility and it really is all dependent on how refineries on the West Coast are run throughout the driving season."

Refiners have channels available to "put barrels on the water," bring in ships with new inventory, whenever they want. They simply are looking for market signs as to when it is advantageous to do it. Under the current rules, it's almost never to their advantage to bring barrels in quickly because they make less money when there is more gasoline. That is why this Commission must limit the profit taking during times of limited supply. Then companies will use their channels to put more barrels on the water if the only way to make more money is to make more gasoline.

The "get around" described by Stillwater -- for refiners to profit-take more throughout the year without the impetus of a supply disruption -- would open them up to legal consequences and prosecution for anti-trust and price fixing allegations that they carefully avoid.

In a highly concentrated market, such as California's refining sector, what is considered conscious parallelism or parallel conduct -- where all refiners keep inflated prices all the time -- poses a big risk to trigger anti-trust action.

Antitrust authorities consider factors such as the level of market concentration, the transparency of pricing in the industry, and the ease with which companies can monitor each other's prices -- all factors common in California's refining market when evaluating parallel conduct. In highly concentrated markets, parallel behavior is more likely to raise suspicions because fewer firms control the market. Antitrust authorities look for "plus factors," which are circumstances that indicate the parallel actions are likely the result of an agreement rather than coincidence. These might include communications between competitors, the exchange of sensitive information, actions that are against the individual company's interests unless pursued as part of a collective strategy, or a pattern of behavior that systematically follows the lead of one company.

The sharing of terminals, common supply and pricing information (through OPIS and Lundberg survey), and routine sharing of information among traders would open refiners to anti-trust prosecution should they keep prices in California higher all year long to yield a higher profit without the cover of a disruption in a market. Market disruptions are necessary to generate the supply demand imbalance that justifies higher profits. By limiting profit taking during these episodes through a max margin you can stabilize the market.

Companies often defend against accusations of illegal parallel actions by demonstrating legitimate business reasons for their behavior. Sustaining higher prices and profits year long in the absence of such legitimate reasons -- supply disruptions -- would create great legal peril for the companies who maintain the higher prices/margins without such reasons. The market is so

consolidated and there are so many feasible mechanisms for collusion due to the widespread information sharing in the industry anti-trust regulators would have a basis to act.

It would be disingenuous policymaking to fail to implement a maximum price gouging penalty because the Commission fears refiners will collude to keep prices higher than warranted. It's the equivalent of giving into terrorists when we have laws that penalize terrorism.

Questions for Establishing a Maximum Margin

2) How should a maximum margin be designed and how should it be implemented with the goal of encouraging appropriate market behaviors? Include the following: At what value should the maximum margin be set (\$/gallon)? Include a discussion as to why the maximum margin should be set at that value and not higher or lower, and why that set maximum margin provides the greatest benefit to consumers.

Should the maximum margin be changed periodically? If so, at what frequency (daily, monthly, quarterly, etc.) and why?

Appropriate market behavior occurs when market players compete with each other. In a market with few players, the players may work together legally to maximize their profit but the law also limits in what ways players can work together. The assumption the Commission must start with is the market can be competitive if incentives are properly aligned and the maximum margin is about realigning incentives.

A penalty should be designed to discourage price/profit spikes resulting from limited inventory situations and encourage a market where adequate inventories lead to stable prices and profits.

At what level the maximum gross margin is set depends, in part, on what benchmark you are using to set the margin: rack prices or all channels, including Deal Tank Wagon (DTW). SBx1 2 specifies rack prices as a benchmark.

The maximum margin should be set at a tiered rate beginning in the 70 to 75 cents per gallon range. This is a very high threshold historically.

- The average margin in the CEC's M1322 data over the last ten years, which include the unprecedented margins of 2022 and 2023, was 68 cents per gallon (Jeremy Thomas presentation Implementation workshop 4/11/24) Excluding 2022 and 2023, the average margin is 64 cents per gallon for 2013 -2021. This data set is the most accurate data available as it is reported by the refiners based on California gasoline only under SB 1322. This data is not volume adjusted.
- Similarly, the other data presented by the CEC (Data Source: EIA, OPIS, CDTFA and Alaska Department of Revenue, presented at Implementation Workshop 4/11/24)

shows that during the last tens years refiners' gross margins did not surpass 70 cents per gallon except in 2022 and 2023.

- A 20 year [look back of investor reports](#) filed with the Securities Exchange Commission by Consumer Watchdog show that West Coast refining margins (which include gasoline, diesel and jet fuel) exceeded 50 cents only three times (all by Chevron) prior to 2022.
- Recent West Coast refining margins reported to investors and the SEC for the 4th quarter of 2023 and 1st quarter of 2024 for California's five big oil refiners show a range of gross margins (including gasoline, jet fuel and diesel) between 30 cents per gallon and 57 cents per gallon.

A 70 cents per gallon maximum margin is on the very high end of refiners' margins, targeting "extreme profits". Application of the penalty should be weekly or monthly depending upon the capacity of the CEC to monitor margins. Monthly would align with current reporting under SB 1322.

70 cents is a high enough threshold to incentivize participation in the market, particularly as it is tiered and refiners would still keep a significant percent of profits at that level. Nonetheless it would discourage the extraordinary \$1 plus margins of 2023 and 2022 which take a bite out of consumers' pockets.

When margins are that high, the price gap with US gas prices is typically \$1.30 or more, despite the fact that only a gap of 80 cents is justified based on the added environmental and tax costs in California.

A 70 cent maximum gross margin will discourage the profit taking that comes with price spikes and incentivizes shortages in the market that lead to price spikes. During price spikes, margins typically exceed \$1 or more. If companies are not able to retain the profits from those margins then they will have an incentive for a more stable market with adequate inventories.

Setting a maximum gross margin does not require a look operational costs of California refiners. Historical margins are sufficient to determine the penalty level. However, reports to investors and the Securities Exchange Commission by California refiners that report operating costs show [West Coast operating costs](#) from 4th Quarter 2023 in the range of 20 to 30 cents per gallon, including all overhead costs form operating costs, appreciation and amortization and turn-around costs. First Quarter 2024 reports are consistent with the 4th Quarter reports as well. This is a far more accurate picture of operating costs than those presented by refiners to the CEC as they are filed under penalty of liability by the companies.

3) How would the proposed maximum margin design further the statutory goals and promote a better balance between supply and demand in the California transportation fuels market than would exist without the maximum margin and penalty? Discuss the impact to supply and demand in the California transportation fuels market if a maximum margin was set and a

penalty established. In the discussion, include estimated changes in the volumes of gasoline produced by refineries and estimated changes in volumes consumed.

The goals of SBx1 2 are clear from its findings, to prevent “opportunistic price gouging by oil companies,” and prevent extreme profit taking cited in the findings: “Indeed, during a 90-day period in 2022, refiners earned a record \$63,000,000,000 in profits, with some refiners earning more than tenfold their profits for the same period of time in 2021. Refiners’ annual profits for 2022 also set new record highs.”

As stated in the law, “Fundamental change is necessary to prevent future extreme price spikes and price gouging by oil companies, which are entitled to a reasonable return but are not entitled to reap exorbitant profits at the expense of Californians, many of whom rely on gasoline as an essential commodity or who are impacted by the increased cost of goods and services that results from the gasoline price spikes, even as the state begins to transition away from dependence on the fossil fuels that are destroying our climate.”

A maximum margin set at 70 cents per gallon would promote more supplies over limited inventories that could no longer produce “extreme profits.”

Since the maximum margin is a profit cap, not a price cap, it would not restrict supplies but incentivize greater supply. Refiners will have an expectation of their profit level and be entitled to that level regardless of crude and other raw material costs. They will be able to pass these hard costs onto consumers. The primary cost impacts in California are the price of oil at the New York Harbor and the portfolio of taxes imposed on consumers, both of which are accounted for when adjusting for a maximum gross margin. Absent reconfiguration of refineries – a lengthy and highly expensive process – refinery costs are fixed in the short run – reflecting only labor, electricity, minor inputs, oil and taxes. The stable profit structure creates an incentive for market participation and allows for the changing costs of crude and other raw materials. This guarantees refiners the “reasonable return” cited in SBx1 2 but protects consumer from the “exorbitant profits” that can be reaped “at their expense.”

The maximum margin should not have an impact on the overall amount of gas consumed or supplied over the course of a year. It should increase the amount of gasoline supplied at critical moments when inventories have traditionally been low and led to price/profit spikes.

In the current environment, with two refineries now offline in Northern California due to their conversion to biodiesel, there is an incentive not to bring barrels in on the water in order to keep a tight market and reap greater profits. A maximum margin, by eliminating the possibility of extreme profit taking, will encourage the import of more gasoline to fill gaps from reduced production.

4) How would the proposed maximum margin design guard against higher average prices at the pump on an annual basis? Discuss the potential financial impact(s) to consumers of setting a maximum margin and penalty. The financial impact should consider the price that consumers pay at the pump and may also consider changes in other costs such as shipping and consumer goods. Include the estimated change of the price of gasoline (\$/gallon) and justification for the estimate.

The higher average price paid by consumers is heavily influenced by price spikes because of the “up like a rocket, down like a feather” phenomenon. When prices go up quickly in the current market, they tend to take a long time to fall, leading to higher average prices on an annual basis. By disincentivizing the price rocket and subsequent feather fall, the maximum margin will keep annual prices lower and more stable.

In terms of the import of gasoline, the costs of transporting gasoline to California are balanced out by the reduced costs of making gasoline in a lower wage, lower operating cost environment elsewhere in the Pacific Rim. The average operating costs reported to investors by major refineries in California is \$8.40 USD - \$12.60 USD/barrel⁴. In Singapore, however, the operating costs peaked at \$7.81 USD/barrel in 2023, putting the highest operating costs in Singapore below California refineries’ lowest⁵. Further, a search of job postings at refineries in Singapore revealed that an Analyzer Technician position at ExxonMobil Jurong Island Refinery starts at \$1,482 USD/month, or \$17,784 USD/year⁶. That hourly rate of \$8.55 USD/month is just over half of California’s minimum wage of \$16.00/hour⁷.

5) What factors should be considered when assessing the potential impacts on disadvantaged and low-income communities from establishing (or not establishing) a maximum margin and penalty?

The disadvantaged communities suffer the most from sudden gasoline price spikes because they do not have flexible budgets. Stable gasoline prices are critical for low income communities and a maximum margin encourages stable prices because it penalizes price spikes.

⁴ <https://consumerwatchdog.org/wp-content/uploads/2024/03/Investoroperatingexpensesource.pdf>

⁵ <https://www.pertamina.com/en/news-room/news-release/efficient-pertaminas-refinery-operational-cost-is-lower-than-singapore>

⁶ https://www.jobzmall.com/exxon-mobil/job/analyzer-technician?utm_campaign=google_jobs_apply&utm_source=google_jobs_apply&utm_medium=organic

⁷ https://www.dir.ca.gov/dlse/minimum_wage.htm#:~:text=The%20minimum%20wage%20in%20California,%2416.00%2Fhour%20for%20all%20employers.

6) The CEC is authorized to grant case-by-case exemptions from the maximum margin for good cause. What factors should the CEC consider in making such determinations?

Factors that should be considered for exemptions include extraordinary capitol expenditures that a refinery may need to make, such as the replacement of a fluid catalytic cracking unit. When refineries need to make significant safety improvements, the capital costs of the improvement should be considered and make the company eligible for exemption.

In addition, exemptions should be considered for refiners that keep added inventories on hand. While theoretically such supplies guard against a run up in margins, there could be a circumstance, such as with Exxon Torrance explosion, where events conspire to lead to higher than usual margins. Refiners that keep extra inventories on hand to deal with such problems and stabilize the market should be rewarded in the short term for keeping those inventories and eligible for an exemption from the maximum margin. This incentivizes a stable market, which should be the goal of a maximum margin design.

7) In addition to the non-exclusive considerations set forth in the statute, are there other factors that the CEC should consider for determining whether and at what level to set a maximum margin and penalty?

In 2001, the Federal Energy Regulatory Commission (FERC) finally set a region-wide price cap on wholesale electricity. The California energy crisis ended abruptly – doubtful plant closures, unreasonable economic bids, and imaginary transmission paths ceased suddenly. This was all the more surprising given that the regional supply/demand balance was worse in the summer of 2001 than the summer of 2000 when the California crisis first took place.

This was not a coincidence. The benefits of penalizing high prices/profits are largely preventative. The risk of market manipulation is the same whether prices (or revenues) are high or low. The primary benefit of setting a maximum margin is that there is little reward for taking the risks of market manipulation, as California discovered on June 10, 2001 – the date that FERC’s west-side price cap went into effect.

Other Issues

We want to point out to the Commission that the two consultants who were invited to represent their views on the max margin at the last workshop have close ties to the industry and appear to have continuing business relationships with the industry.

Both ICF and Stillwater have significant conflicts of interest that should lead the Commission to discount their counsel based on the fact they are not likely to bite the hand that feeds them

and their firms. ICF's Tom O'Connor worked for Exxon Mobil for 30 years and his firm appears to have industry clients, though his client list is not disclosed. David Hackett, who similarly comes for the industry, has been a stalking horse for the oil industry since I began observing the CEC two decades ago and his firm appears to represent the industry as well. The CEC should require full disclosure from both Stillwater and ICF of their current and past list of oil industry clients, put it on the record, and consider the source of their advice carefully.

Sincerely,

A handwritten signature in black ink, appearing to read "J. Court". The signature is written in a cursive, fluid style with a large initial "J" and a stylized "Court".

Jamie Court
President