"Petroleum Windfall Profits Penalty: Will Californians get relief at the gas pump?"

Analysis By Michael Mische
Before the
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Senator Steven Bradford, Chair

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PRICE GOUGING PENALTY

Definition

A price gouging penalty or windfall profit tax is an additional income tax or penalty levied on profits that are deemed by a governing body to be "excessive" and above some arbitrarily determined and statutorily defined threshold.

A Windfall Profit Penalty Creates Contention & Many Questions

- How is a windfall profit defined?
- What created the windfall profit?
- On what amount should a windfall profit penalty be imposed?
- When is a windfall a windfall?
- When are profits excessive?
- How long do profits have to remain "high" to be excessive?
- If profits are excessive one year, to what extent can they be used to compensate for years in which losses were incurred?
- If profits increase substantially due to capital investment, technological breakthroughs, innovation, and production efficiencies, then are those profits a "windfall"?
- Should companies that generate significant profits due to market conditions and management acumen be penalized for high financial performance?
- To what extent is the imposition of a windfall profit penalty punitive (and equitable) to the shareholders who incurred risks of investing in the company?

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The imposition of a price penalty on a legislatively contrived profit threshold or realistically, a windfall profit penalty, has underperformed expectations and, in some instances, resulted in negative and unintended consequences.

WHAT IS A "PROFIT GOUGING PENALTY"?

- Sometimes called an "excess profits penalty," "windfall tax," "high profits tax," or "price gouging penalty," the notion of levying penalties on unexpectedly high earnings is not new, nor novel.
- As early as 1917, a windfall profit tax was used in the U.S. to deter "war profiteering."
- Historically, the justification for such a tax or penalty has been to deter and punish an individual or business that engages in market and supply manipulation or predatory pricing practices in times of economic strife such as global political conditions, major wars, unplanned disasters, unplanned interruptions, force majeure, etc.
- More recently, the justification for a windfall profit tax has been expanded to include redistribution of profits for "equity" purposes or economic re-engineering.
- With inflation running at 10.1%, several European countries including Austria, Belgium, Germany, Greece, Italy, and Spain have or are considering imposing a windfall profit tax.
- In the 1970s, after the Arab oil and gas embargo of 1973 and 1974, Congress enacted, and President Carter signed the Crude Oil Windfall Profit Tax Act (P.L. 96-223) on April 2, 1980.
- It was proved to be **ineffective** and was later **repealed** be President Reagan.

According to a 2006 independent and non-partisan Congressional Research Services study, the 1980 tax fell woefully short of its advertised intentions and "benefits." Specifically it:

- Resulted in an **80% shortfall** in actual gross tax revenues to the government as compared to projected gross revenues.
- **Reduced** domestic oil production by as much as **4.8%**.
- Forced an **increase in dependencies** from foreign sources and an **increase in imports** by as much as **12.7%**.
- **Reduced** U.S. oil company **investment and capacity** to discover and cultivate new oil fields.
- Resulted in **little meaningful reduction** in **retail gasoline prices** for consumers.

Additionally:

- Spain's results with excessive profits taxes have also **fallen short** of expectations.
- UK producers have already singled a **reduction** in capital investment in new production technologies and exploration.

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THE CASE HASN'T BEEN MADE FOR PRICE GOUGING PROFITEERING

ISSUES TO CONSIDER

- Merely considering refiner prices and profits as the source for high retail gas prices is both incomplete and misleading.
- The retail pump price reflects downstream costs and operating costs incurred by the retail gas station operator.
- California is not only dependent on its in-state refineries but those in the western part of the U.S. Refining capacity in the western states, which California relies upon, has declined 22% since 2007 and fell another 12% from 2019 to 2021.
- Refining operations are sensitive to weather and experience both planned and unplanned outages.
- Gas prices spiked in California in 2015 after a refinery fire in Torrance and remained above the national average for 2016 to the present.
- Retail prices spiked again because of another Torrance fire, weather shutdowns, and planned shutdowns in October 2022. Events whether planned or unplanned, disrupt refining operations and adversely impact supply and drive-up retail prices.

VARIOUS STUDIES, CASES AND RESEARCH HAVE YET TO PROVE WIDESCALE PRICE GOUGING OR PROFITEERING

- After numerous investigations during the 2000 to 2019 period, the California Attorney General found that gasoline stations in the state did not engage in price gouging.
- As Governor Newsom was alleging "rip-offs," and after thousands of hours of discovery and depositions and pages of documents U.S. District Court Judge Jinsook Ohta, San Diego, issued a 103-page reasoned order tossing a case of alleged price fixing by fuel industry producers.
- By law, businesses in California, as well as some forty-two other states, are forbidden to engage in price gouging and there is little incentive for businesses as large and sophisticated as Big Oil and refiners to do so.
- Since at least 1910, the proven instances of Big Oil price gouging are rare and, although easy to allege, difficult to prove with specific and valid examples.
- On a national level, after years of multiple investigations and hearings by the Federal Trade Commission (FTC) there is no direct evidence of widespread price gouging by gas stations or American oil and gas companies.
- According to a March 2022 study released by the Federal Reserve Bank of Dallas, "the elevated retail gasoline prices must be attributed to events in the U.S. retail gasoline market beyond the control of oil producers."

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Enacting SBX1-2 will have negative consequences for California

Although the motivations for SBX1-2 are laudable and are to be commended for its mindfulness of the California consumer…as constructed, it is:

- Poorly crafted and incomplete in its specificity.
- Does not provide for how taxes are to be collected and, importantly, how much will be remitted back to those who paid for gasoline.
- The imposition of SBX1-2 will only make matters worse for the California consumer.
- Enacting this legislation will only serve as a disincentive for investing in supply and new technologies for the refiners.
- Enacting it will reduce supply, force out producers and reduce employment in a high-paying sector.
- Relies on a gross margin calculation that is relatively primitive and lacks major components that shape cost and profit.
- Ultimately driving up gas and energy prices for consumers.
- Does not address the real causes of high gasoline prices attributed to the laws of economics, high cost of doing business, regulatory costs, production restrictions, and the need for greater supply and production.

RECOMMENDATION:

ENACTING SBX1-2 IS NOT IN THE BEST INTERESTS OF THE CONSUMER, WILL NOT REDUCE RETAIL PUMP PRICES, AND IS NOT IN THE BEST LONG-TERM ECONOMIC INTERESTS OF CALIFORNIA.

THERE ARE BETTER ALTERNATIVES.

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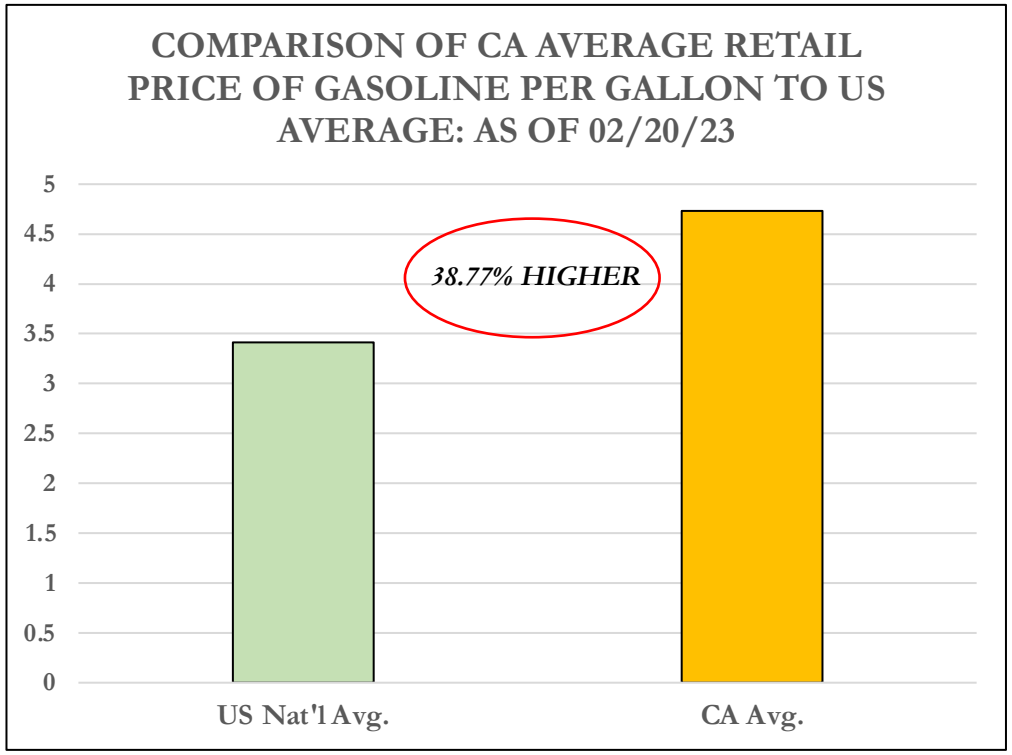
96% OF CALIFORNIA GASOLINE PRICES CAN BE EXPLAINED…A SIMPLE DISGORGEMENT



EXCESSIVE PROFITS ARE NOT GENERATED AT THE REFINERY LEVEL…COSTS ARE CUMULATIVE

DISGORGEMENT OF RETAIL PRICE BASED ON COST COMPONENTS		
Cost Component	**US Nat'l Avg.**	**CA Avg.**
Total Retail Price (as of 02/20/23)	**3.41**	**4.732**
Federal Excise Tax	0.184	0.184
Federal UG Storage Fee	0.02	0.02
Station Profit (assumed)	0.1	0.1
CA State Excise Tax	0	0.539
CA Cap & Trade Assessment	0	0.23
CA Carbon Fuel Emissions	0	0.15
CA Underground Storage	0	0.02
CA State & Local Sales Tax (avg.)	0	0.14
CA Special Gas Blend Addt'l Cost	0	0.1
All Other Taxes, Fees, Costs & Profits	**3.106**	**3.249**
Retail Price Difference		**0.143**
Retail Price Percentage Difference		**4.604%**

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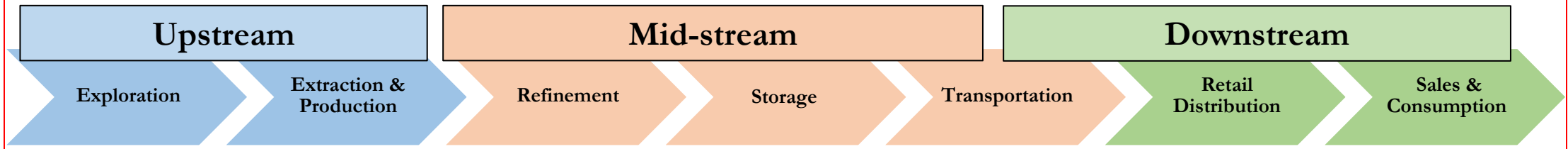
The retail gasoline supply chain is complex and extended. Costs and value are added at multiple stages which, in turn, increase pump prices.

- At each stage of the supply chain, value is created and added to the crude oil which contributes to the build-up of costs. The accumulation of costs is ultimately reflected in the retail price of gasoline.
- Final pricing at the pump reflects the **build-up of costs**, plus local conditions, local costs, local demand, regulatory costs, and level of local competition.
- In addition to the basic laws of supply and demand and wholesale prices that the gas station owner/operator pays are influenced by refinery operations, weather, seasonal factors, and different gasoline formulations (blends).



Cost of Production	Wholesale Cost	Consumer Cost

Costs are cumulative over time and over the entire chain and are ultimately reflected in the retail "pump" price.

Downstream costs, inclusive of regulatory costs, are large contributors to consumer gasoline prices.

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BASIC SUPPLY AND DEMAND TELL A STORY

SUPPLY FACTORS

- Gasoline is made from oil, which represents about 55% to 59% of the total cost of gasoline.
- The price of oil fluctuates by the minute and is sensitive to not only supply and demand, but also geopolitical events, weather, operational interruptions, government policies, etc.
- California supply is constrained. CA produces only around 25% of the oil and gas that it consumes and imports 75% of its crude oil, which makes CA highly dependent on foreign, non-domestic sources.
- According to the EIA, one barrel of oil which contains 42 gallons, produces about 18.9 to 22 gallons of gasoline, or about a 45% to 52% yield input to output rate depending on quality of crude and refining efficiencies.
- About 29% is refined as diesel fuels,10% is jet fuel, and the reminder is for petroleum related products.

DEMAND FACTORS

- California consumes around 48 million gallons of gas a day, and about 10 million gallons of diesel fuel per day, or 58 million barrels a day.
- California consumes around 1.8 million barrels of oil a day, which makes the state second highest consumer of petroleum in the U.S.
- California gas is special gas and unique to California and is blended to a particular formula depending on the season. That blend is not used by other states; hence, the market for the blend is restricted.

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RECENT PRICE MOVEMENTS ARE AN ANOMOLLY

- **Cyclicality.** The oil and gas industry is highly cyclical and subject to the laws of supply and demand. The industry and therefore oil and gas prices are highly sensitive to geo-political events, such as those in the 1970s and more recently, Russia's invasion of Ukraine. The supply of crude oil and therefore, gasoline is also affected by weather conditions, including the Winter Cyclone Bomb hitting the U.S. in December 2020.
- **Macro Economy.** Demand for oil and gas is closely related to macroeconomic activity and GDP. When the economy expands, the demand for oil and gas products increases; when the economy contracts, so does demand. When other countries, such as China experience fluctuations in their economy, the world price of oil and gas is influenced. China's $18 trillion economy is still in pandemic lockdown and is slow to recover, but once it begins to recover, the demand for oil and its price on the world markets will most likely increase.
- **Pandemic Demand Destruction**. In the U.S., early indications of a major health issue began to manifest in October 2019 and reached pandemic proportions by March 2020. In response, national, state, and local governments initiated mandatory lockdowns, shutdowns, stay-at-home orders, and other measures which, naturally resulted in a dramatic decline in economic activity.
    - As schools closed, businesses were shut down, and employees were ordered to "stay home," travel declined, airlines cut schedules, and long-established supply chains began to deteriorate. Refineries shuttered large portions of their capacity, reduced workers, and operated at lower production levels…all of which are logical business actions.
    - According to AAA, in January 2019, before lockdowns and shutdowns were mandated by state and local governments, Californians paid the highest price for retail gas in the U.S. at $3.72 a gallon versus a national average of $2.61, or 42% more.

- **Profit Destruction.** For almost all businesses, large or small, 2020 and most of 2021 were not good years. Downtown vacancy rates climbed, states such as California lost both businesses and population, and state and local tax bases collapsed. Big Oil and California operators were not immune.
    - When prices and profits fell in 2020, and Exxon Mobile lost over $22 billion dollars, and Chevron lost $5.7 billion there was little political and media attention, and California refineries were reducing employment and sustaining losses, the Governor and Legislature remained ideally silent.
    - In 2014, 2015, and 2020, big oil companies sustained tremendous losses. For 2020, collectively, the "Big Oil" companies, BP, Chevron, Exxon Mobile, and Shell, sustained $76 billion in losses when the price of oil dropped to negative value.
- **Pandemic Recovery.** It was only after the 2021, relief of stay in orders that the U.S. began to recover from the pandemic and, big oil profits began to soar. However, despite claims that inflation would be transitory, inflation soared to near 40-year highs, which in turn, drives up gasoline prices.
- **2022 Profit Resurgence.** Big Oil profits rebounded in 2022 and surged from 2020 losses in a big way. The profit resurgence is the consequence of inflation, which increase gasoline prices, and the reality that demand grew faster than the supply could support, which contributed to the increase in gasoline prices. Add in California's special blends and dependence on foreign oil supplies and it is no secret as to the impact on prices. Combine those dynamics with mandatory special blends, refineries having to re-boot after shutting down, and workers being recalled, and prices will go up…and they did. On the world stage, where California is heavily dependent, the price of oil, the main ingredient of gasoline, skyrocketed. Gasoline prices in the U.S. were further augmented by political policies that curtailed production on federal properties, slowed permitting, and prohibited new pipelines and building of new distribution infrastructure.

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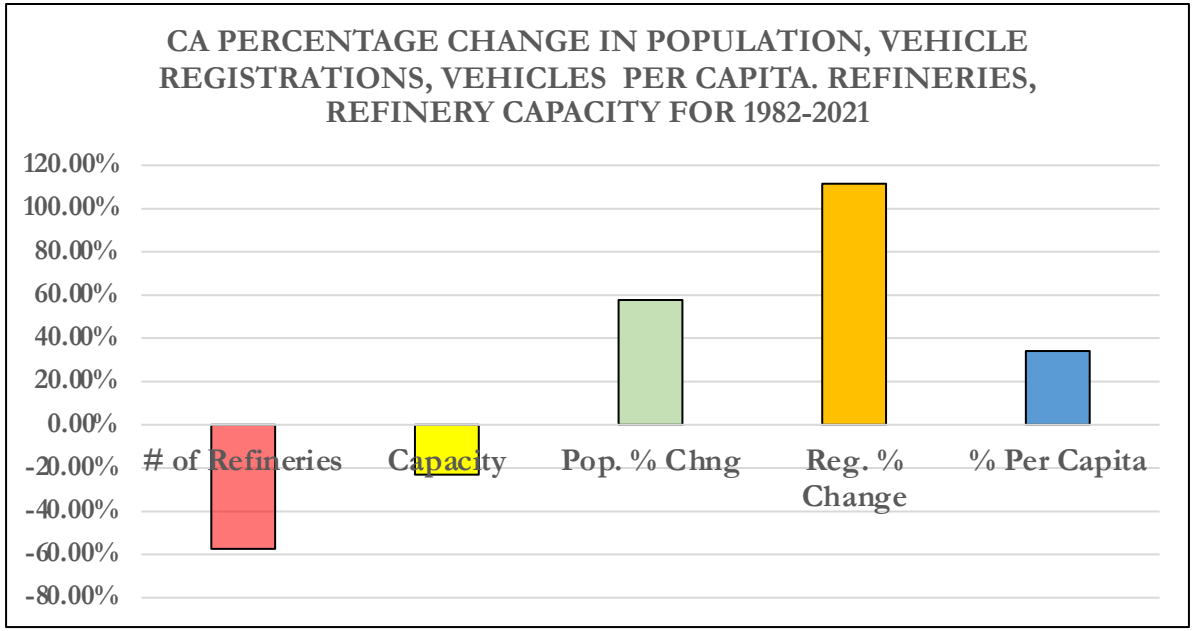
CALIFORNIA OIL & GAS PRODUCTION HAS NOT KEPT PACE WITH DEMAND DRIVERS

- Since 1982, California's refining capacity has decreased by 23.07%, and the number of refineries plummeted by 57.7%.
    - In 1982, California had 40 refineries with a daily capacity of 2.6 million barrels per day.
    - In 2022, there were 17 refineries with about 2 million barrels per day in capacity.
- As California's refining capacity decreased, its population and motor vehicle registrations surged by 58%, and 111%, respectively for the 1982 to 2021 period.
- California's domestic production of oil has steadily declined at around 7% a year from its 1985 high.



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CALIFOIRNIA IS HEAVILY DEPENDENT ON FOREIGN OIL & IS VULNERABLE TO WORLD PRICE MOVEMENTS & SUPPLY DISRUPTIONS

- Based on California's own data, almost 25% of non-domestic oil imports came from Ecuador, which was the largest foreign provider of oil to California.
- California's reliance on Ecuadorian oil, however, comes with an environmental cost as most of Ecuador's oil production is located in the Oriente Basin in the Amazon and there have been instances of environmental damage to the Amazon rain forests and river basin.
- Oil produced from the Oriente Basin is some of the "heaviest" oil produced in the world, making it some of the dirtiest with high greenhouse emissions of 1.5 to 2 times higher than that of oil produced in Texas.
- According to oilprice.com, "Oriente is a medium sour variety with an API gravity of 24 degrees and a sulfur level of 1.4%. Oriente accounts for around two-thirds of Ecuador's oil exports."

- California is highly dependent on imports of oil from foreign sources, including Saudi Arabia, Ecuador, and historically, Russia, as well as those from within the U.S. (Alaska).
- The imports are used by California refiners to produce the gasoline that is unique to California mandates.
- To pay for the imports, Californians export about $73-$100 million a day or $325-$445 billion annually, to foreign suppliers most of which are owned, or majority-owned, by their governments.

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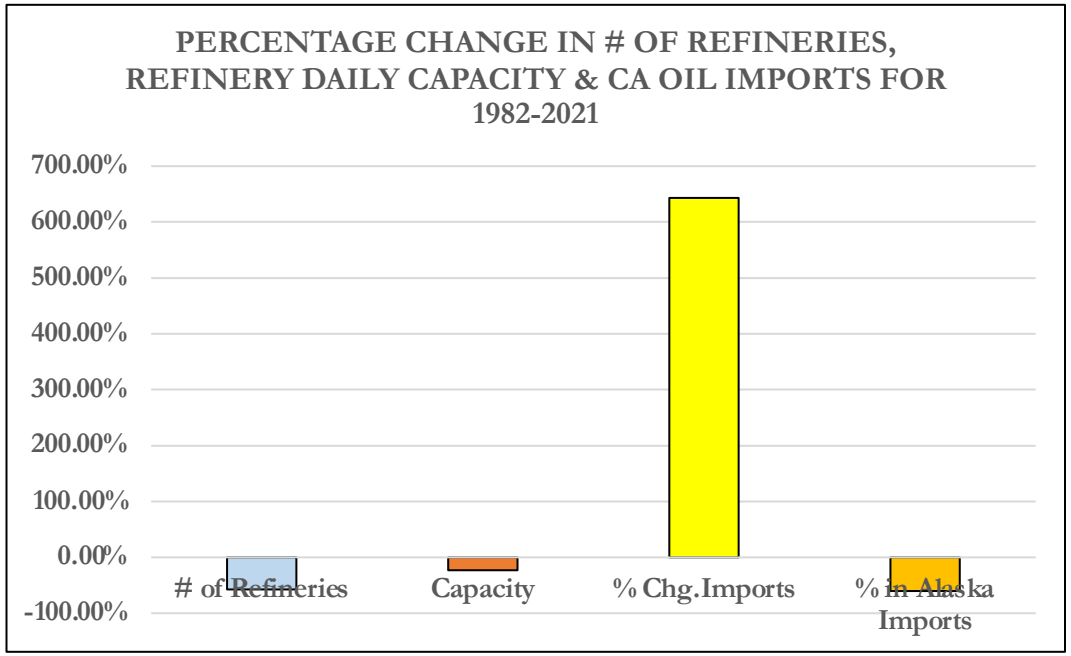
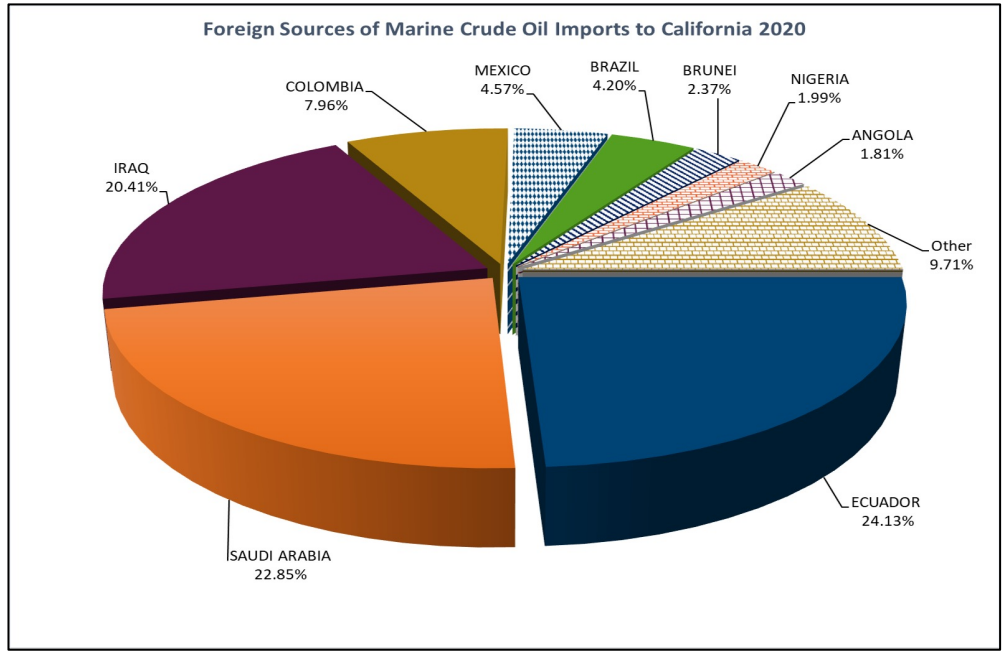
CALIFORNIA PRODUCTION HAS DECLINED AND DEPENDENCY HAS SOARED





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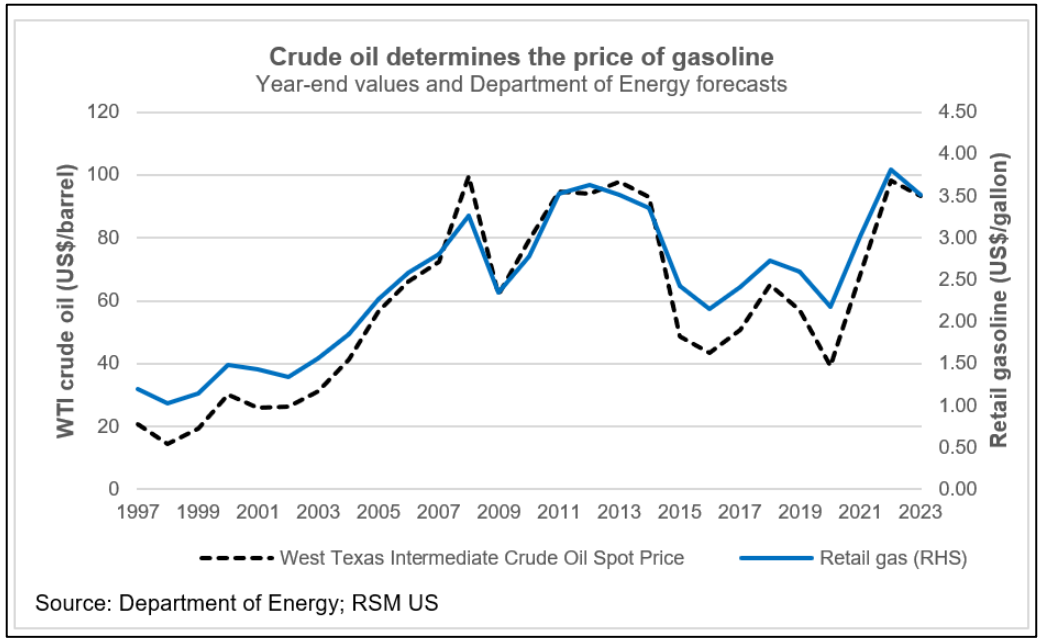
CRUDE OIL PRICES DRIVE GASOLINE PRICES… THE HISTORICAL SPREADS DO NOT INDICATE PRICE GOUGING AT THE PRODUCTION OR REFINERY LEVELS… CONSUMER PRICES ARE CUMULATIVE

CRUDE OIL PRICES DRIVE RETAIL GAS PRICES



MANY FACTORS INFLUENCE THE PRICE OF CRUDE OIL AND ULTIMATELY THE PRICE OF GASOLINE

- Crude oil is a commodity, and the price of crude oil is ultimately determined on various world markets based on the fundamental laws of supply and demand.
- In petroleum, there is a world market that determines the cost of crude oil per barrel. There are over 150 different markets for trading oil and setting oil prices.
- The price of crude oil is constantly changing and is based on the economic fundamentals of supply and demand, as well as political policies. Oil is currency and a powerful economic asset (and weapon) and since 77% of the world's oil reserves are state-owned or state-controlled, the spot price for crude oil can be, and often is, heavily influenced and manipulated by state-owned producers, and their governments.
- Other factors influencing prices include weather, geopolitical conditions, CEO sentiment about the future, free cash flows to invest in production and refinery technologies, refinery efficiencies, refinery maintenance and shutdown schedules, quality of raw oil used, types of products made and capacity utilization. Capacity utilization between 89% to 95% generally yields highly efficient production, economies of scale and greater operating margins.

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REFINERY COSTS ARE HIGHLY CORRELATED TO THE PRICE OF CRUDE OIL, WHOLESALE PRICES AND CONSUMER PRICES

The correlation suggests that "profiteering" is not occurring at the refinery levels.

Correlation of yearly values -- 1997-2022

	WTI	*Refiner cost*	*Wholesale gas*	*Wholesale gas markup*	*Retail gas*	*Retail gas markup*
WTI	1.00					
Refiner cost	0.99	1.00				
Wholesale gas	0.99	0.99	1.00			
Wholesale gas markup	0.59	0.58	0.68	1.00		
Retail gas	0.98	0.98	1.00	0.71	1.00	
Retail gas markup	0.60	0.62	0.67	0.72	0.74	1.00

Source: RMS

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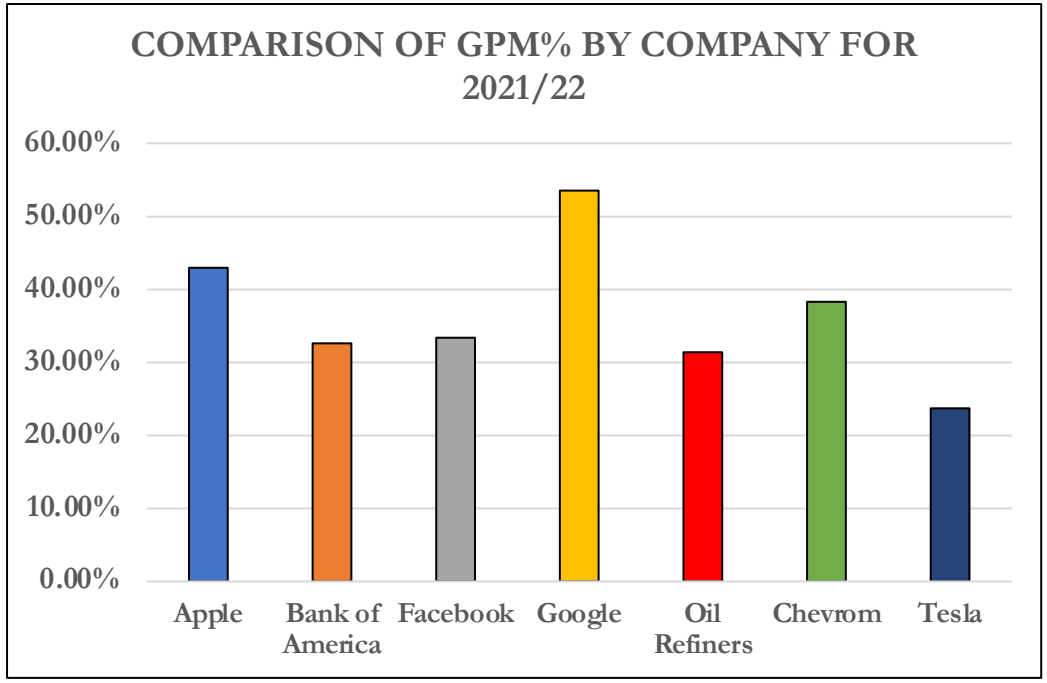
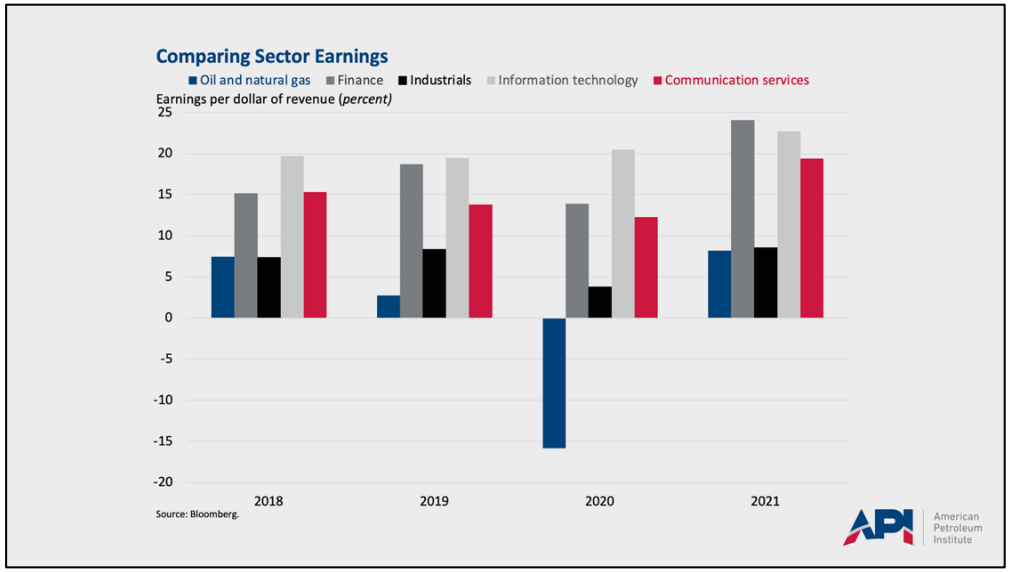
OIL PRODUCER & REFINER MARGINS & PROFITS ARE HIGHLY VOLATILE & ARE SUBJECT TO WIDE VARIATIONS…RECORD EARNINGS IN 2022 AND LOSSES IN 2020

OIL REFINERS, DESPITE RECORD EARNINGS LAG BEHIND HIGH TECH COMPANIES IN GROSS MARGINS



COMPARISON OF OIL COMPANY EARNINGS TO OTHER SECTORS



FOR 2023, THE CONSENSUS OF ANALYSTS IS THAT OIL & REFINERY MARGINS WILL DECLINE.

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ON A PER GALLON BASIS, THE STATE MAKES MORE THAN THE GAS STATION OWNER-OPERATOR

Retail Distribution…Gas Stations

- Of the estimated 145,000 stations operating in the U.S., approximately 87,000 or 60% are independently owned by an individual or family who operates a small business, or single store at a single location.
- Although "branded" by oil company name, most stations are independently owned and operated.
- After owners pay the wholesale price for the gasoline that they sell and make a modest profit of, say $.10 a gallon, they must pay federal, state, and local income taxes, rents, utilities, worker's compensation, social security, employee wages, accounting, bookkeeping, housekeeping, legal and other costs for the products that they sell.
- Gasoline prices are "sticky" and slow to come down once they go up…but they will react, eventually to the overall market and price of crude.

GAS STATION ECONOMICS TELL A STORY

- Realistically, gas station owners have very little control or influence over the retail pump price.
- Retail gas sales as measured by gallons sold per day vary, by the time of day, season, temperatures, weather, etc.
- Despite the all-time high "pump price," the profit margin for a gas station operator on gasoline sales is notoriously low, at about **1.4%** to **1.9%.**
- Profits from the sale of a gallon of gas range between $.05 to $.15 cents a gallon with historically high averages of around $.092 to $.100 a gallon for a profit margin of 1.8% based on $5.57 a gallon.

COMPARING PROFIT MARGINS: GAS STATIONS TO OTHERS			
Gas Station	Grocery Store	Car Dealership	All Industries
1.40%	2.50%	3.20%	7.70%

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California's high oil and gas prices are the result of extraordinarily interactions involving real-world economics, the geopolitical environment, weather, operations, high dependency on foreign-sourced oil, California's overly complex regulatory environment, high taxes, and mandatory special blends.

WHY ARE GAS PRICES SO HIGH?

- In addition to real-world economics and petroleum production, there are factors unique to California:
  - California gas and energy policies have failed to support the demand for gasoline associated with a forty-year increase in population and motor vehicle registrations.
  - California has become more reliant on foreign oil sources and is vulnerable to world market conditions.
  - California provides no incentives for oil and gas producers to either increase capacities, at scale, or for new refiners to enter the state.
  - California has some of the most severe prohibitions on in-state exploration and production, and long-standing restrictions on refineries that limit supply.
- The cost of doing business in California is almost 39% higher than the U.S. baseline, utilities run almost 23% higher, housing is almost double, and transportation is 24% higher. All of these factor into gas station operating costs and prices.

CALIFORNIA HAS HIGH REGULATORY COSTS

- California has more than 25 federal, state, and local agencies overseeing oil and gas production and is considered to have the most stringent regulations in the world.
- According to the U.S. Energy Information Administration (EIA), California ranks 48th for commercial energy costs. These costs are more than double those of states such as Florida.
- With some 518 state agencies, boards, and commissions regulating business practices, CEOs ranked California 50th out of 50 as the least favorable business environment.

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SOME SUGGESTED ACTION STEPS TO CONSIDER

Immediate Actions that California Can Consider

- Rollback the State Excise Tax to 2021 levels.
- Rollback the Cap & Trade Fees.
- Adopt "operating margin" rather than "gross margins" as the measurement. Operating margins are more inclusive and more descriptive.
- Suspend for a time certain period, special blends and adopt a single blend (temporary) to allow refiners to stabilize production.
- Improve accuracy by realigning the CEC calculation of one barrel of oil equals one barrel of gasoline to be more consistent with industry standards of 49% to 52% yields.
- Improve costing accuracy by using actual weighted costs for crude oil by source rather than Alaska NS.

Long Term Actions that California Can Consider

- **Increasing supply is the quickest and most effective means to reduce retail pump prices.**
- Increase supply through encouraging CA **in-state production** by supporting ABX 1-3 (Bains).
- Decrease foreign oil dependencies and increase U.S. domestically sourced crude oil.
- Increase supply by providing tax incentives to refiners to invest in new production technologies and employment to increase production.

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Thank You!