Our View: The California Exception[1]

Philip K. Verleger, Jr.
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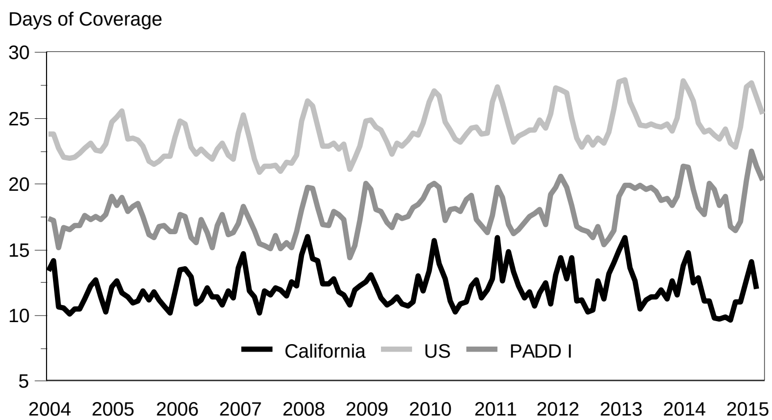
Retail gasoline prices in California surged past $5 per gallon at some locations last week. Buyers were paying $120 per barrel at spot for gasoline complying with California Air Resources Board regulations. California consumers have paid $3 billion more this year than they might have if their markets had been functioning well.

The price jumps have brought out the kooks. For instance, a brain-dead conservative editorial writer for *The Wall Street Journal*, Allysia Finley, blamed high taxes and California's stringent air quality regulations for the spike.[2] She is wrong. However, trade organizations such as the Western States Petroleum Association will trumpet her criticism.

The price increase has brought out even kookier people on the left. A brain-dead leftist, Jamie Court of Consumer Watchdog, blames the price increase on the lack of competition in the oil industry.[3] Court, who is supported by billionaire Thomas Steyer, asserts without evidence that oil companies are violating antitrust laws. He, too, is wrong.

The California price increases can be attributed to very low gasoline inventories in the state. Figure 1 shows the days of forward consumption of gasoline covered by stocks in the nation as a whole, PADD I (the US East Coast), and California. At the end of March, California had twelve days of coverage, PADD I had twenty-one, and the nation had twenty-seven.

Figure 1
Days of Finished Gasoline Supply in California, PADD I, and the United States as a Whole, 2004 to 2015



Source: PKVerleger LLC.

This situation is strange. California is isolated from the

[1] Excerpted from "Iran, Distillate, and California," *Notes at the Margin*, July 20, 2015.
[2] See "Sky-High California Gas Prices Have a Green Additive," *The Wall Street Journal*, July 17, 2015 [http://goo.gl/r15ecp].
[3] See "Californians Overcharged $4.5 Billion for Gasoline "Gouging Gap" since Price Spike Began," Consumer Watchdog, July 9, 2015 [http://goo.gl/CJg5Dr].

world. As many recent reports have noted, it takes weeks to bring incremental supplies of gasoline meeting the state's special requirements from other areas. PADD I, on the other hand, is a short distance from Canada and Europe. Logically, California should hold much higher inventories.

Stocks are low, though, in part because the market there is now dominated by large "big box" retailers such as Costco. During periods of surplus, these firms aggressively seek the lowest possible price, pitting one refiner against another. At times the difference between California retail prices and national retail prices can be less than the incremental cost required to make the unique product required in the state, which indicates the bargaining power of the large buyers. Under such stiff conditions, refiners have no incentive to hold stocks. Indeed, under such conditions, the returns earned by refiners may not even be adequate to maintain their operations.

The solution to California's problems, then, appears to be imposing a gasoline stockpiling responsibility on some part of the industry. Large retailers such as Costco, for example, could be required to hold inventories equal to five or ten days of their sales or to pay a third party to do so. This approach has been successful in Europe.

The June issue of *The Petroleum Economics Monthly*, to be distributed this week, will address California's problems in depth.