The Senate
State of Hawaii

STATE CAPITOL
HONOLULU, HAWAII 96813

October 14, 2005

MEMORANDUM

TO: Senate Colleagues

FROM: Senator Ron Menor RM
Chair, Commerce, Consumer Protection and Housing (CPH) Committee

RE: Fact Sheet on Gas Pricing Law

In order to assist you, I have taken the liberty of putting together responses to frequently asked questions regarding our gas pricing law. I am also enclosing two editorials that were recently published in the Honolulu Advertiser that state the case for the continuation of gas pricing regulation in Hawaii.

I hope that this information will help you in responding to whatever inquiries you may be receiving from your constituents or the general public about the law.

Thank you for your attention to the above matters. Should you need additional information, please do not hesitate to contact me.

Enclosures

Responses to Frequently Asked Questions
Regarding Hawaii's Gas Pricing Law

Did the implementation of our gas pricing law cause the substantial price increases that occurred in the aftermath of Hurricanes Katrina and Rita?

No. There are several factors that caused these price increases, but the primary reason was the abnormal market conditions created by the hurricanes. The catastrophic damage caused by Hurricanes Katrina and Rita caused dramatic price increases throughout the world, not just Hawaii. These problems will not be entirely eliminated until oil and gasoline production facilities are repaired and functioning at 100 percent capacity.

Why are gasoline prices in Hawaii affected by what happens in the Gulf of Mexico?

Gasoline and crude oil are global commodities. They are affected by world events and a shortage in one market has an impact on the amount of oil and gasoline in the global marketplace. No location can be insulated from a catastrophe such as Katrina. Hawaii prices would be as high and possibly higher if our pricing regulation were not in effect.

Aren't our prices higher because the gas pricing law ties Hawaii prices to mainland prices?

No. Historical pricing data clearly shows that Hawaii's gas prices have always been linked to prices on the mainland. Every study, comparing gas prices here to those in the rest of the nation, has shown that every time gas prices increased on the mainland, Hawaii prices also went up or were set at the highest levels. The problem in the past has been that Hawaii prices stayed high when those on the mainland went back down, and the oil companies consistently charged the highest prices in the nation.

A statement made by Bruce Smith, the President of Tesoro, supports this point. After Hurricane Katrina, he told KITV, "Prices would have gone up with or without Hawaii's gas cap law." And he went on to say, "What we are experiencing is the market reacting to a severe supply disruption by increasing prices in order to attract needed supply."

Responses to Frequently Asked Questions
Regarding Hawaii's Gas Pricing Law

Prices seem incredibly high now. Has the gas pricing law stopped oil company gouging?

Not completely. While gas price regulation was adopted to address the well-documented practice of oil companies charging Hawaii consumers excessively high prices, prices today are still much higher than they need to be. That is because the refiners continue to sell gasoline at a much higher price than necessary to make a fair profit. For example, Tesoro's company-owned stations are not affected by the gas price cap because there is no wholesale price involved. They are selling directly from the refinery to the customers and thus are not covered by the wholesale price ceiling. While they could charge less, as they have no middleman, the prices at stations owned by the refiners are actually among the most expensive. This demonstrates again that the gas pricing law is not the cause of today's high prices. This also shows the oil companies' desire to maximize profits is a big factor in keeping prices high at company-owned stations. This is an issue that the Legislature can address next session.

Is Hawaii's gas pricing law working?

Yes. It is beginning to work in three ways:

1. Creating a market in Hawaii that behaves like a truly competitive market,

2. Increasing the choices consumers have in their purchasing decisions, and

3. Creating transparency and accountability in the setting of gasoline prices.

What's the evidence that the law is working as intended?

Since the gas pricing law went into effect, Hawaii gasoline prices have reacted to events as prices would in a normal market. Not only did prices go up with mainland prices after Hurricane Katrina, but for the first time, Hawaii prices went down substantially along with mainland prices afterwards. Thanks to our gas pricing law, retail prices dropped 20 cents to 53 cents per gallon after prices in mainland markets began falling after Hurricane

Katrina. They will fall even further as the mainland market recovers from the price shocks caused by Hurricane Rita. Given the past pricing behavior of the oil companies, these substantial price decreases would never have happened if we did not have a gas pricing regulation in effect that required the oil companies and wholesalers to significantly lower their prices.

A direct comparison of the prices charged by company-operated stations, which are not covered under the gas pricing law, and those charged by stations subject to the law shows that the gas pricing law caused the price reductions we saw between Hurricane Katrina and Hurricane Rita. Consider that during this period prices at the company-operated stations remained substantially higher much longer than at the stations affected by the gas pricing law. Pricing regulation put a lid on prices at stations covered by the regulation, while company-operated stations, playing under the old rules, charged whatever they wanted, just like they have done in the past.

Someone said the point of the gas pricing law wasn't to lower gasoline prices. Is this true?

No. The point is to make Hawaii prices follow the normal price fluctuations in mainland markets. And when mainland prices go down, Hawaii prices will decrease as well. Enabling consumers to get the benefit of this decrease IS the intent of the gas pricing law. Now, with the gas pricing regulation in place, Hawaii prices won't stay up, or even increase, when mainland prices are falling.

Besides ensuring Hawaii gas prices mirror competitive mainland markets, what other benefits does the gas pricing law provide?

The gas pricing law has created a wide range of retail prices that gives Hawaii consumers the greatest opportunity ever to shop for the best price in gasoline, just like they do for other purchases. Prior to the implementation of our gas pricing law, most stations charged basically the same prices, which were set at the highest levels. Some critics of the gas pricing law say that shopping for the best gasoline price is a bad thing. But in a normal marketplace, it is typical consumer behavior to shop for the best price in every product, from laundry detergent and cars to clothing and food. Why should the gasoline market be any different?

Are there any other benefits consumers get from the new regulation of gas prices?

Hawaii's gas pricing law has created a degree of transparency in the setting of gas prices that we've never seen in our state. Consumers now know on a weekly basis how prices will be set. In the past, the setting of gas prices was left to the unbridled discretion of the oil companies in an unregulated market. In addition, there is now greater accountability, since oil companies and wholesalers can no longer increase prices at will, but are now required to petition the PUC for any upward adjustments to the price ceiling.

Is Hawaii out of line in trying to regulate wholesale gas prices?

Not at all. It should be emphasized there is a long, successful history of states regulating industries that provide essential products, like energy, in non-competitive markets. Electricity is a good case in point. Gasoline in Hawaii, which is certainly an essential product for consumers and businesses, has historically been dominated by only two companies and has essentially been an uncompetitive market.

What research or fact finding did the Legislature utilize to make a decision on establishing our gas pricing law?

A considerable amount of time, research, and thought went in the crafting of our gas pricing law. The original law, Act 77, was passed during the 2002 session. Then, during the 2004 session, the Legislature passed Act 242. From the 2002 to 2005 legislative sessions, legislative committees in both houses of the Legislature conducted numerous hearings on this issue and received input from industry experts and representatives, consumer advocates, and concerned citizens. We also consulted with the State Attorney General's Office and the private attorneys and economists who advised the state in its gasoline price-fixing litigation against the oil companies in the 1990s.

In addition, the legislative committees reviewed volumes of data and studies regarding the gasoline industry, and gas pricing not only locally, but also throughout the United States and worldwide.

The legislative committees also reviewed the findings from the state's antitrust lawsuit, which demonstrated a clear need for the state to step in and regulate the pricing practices of the oil companies in order to protect the interests of consumers. The state's expert reports were the most detailed study ever conducted of the Hawaii consumer gasoline market. After years of investigation, using detailed and confidential information from the oil companies, the state's experts reached several critical conclusions: (1) the huge differences in Hawaii and mainland gas prices that have occurred for decades are primarily attributable to windfall profits by the oil companies, profits much higher than normal profits by industry standards, and (2) the reason the oil companies could make excessive profits, resulting in high gas prices, springs from the fact the Hawaii market is structured as an oligopoly, a noncompetitive market with only two sellers who could charge Hawaii's consumers whatever they wanted. As one of the attorneys representing the state in its antitrust lawsuit stated, "The lesson of history is that Hawaii gasoline prices will not get down to competitive levels without government pressure." This is the reason why the Legislature chose to regulate Hawaii's wholesale gasoline industry.

Why are Hawaii's prices still the highest in the nation?

This question needs to be put in its proper perspective. Prior to the implementation of the gas pricing law, Hawaii's gas prices were consistently the highest in the nation. However, subsequent to the implementation of the law, there were periods of time when Hawaii's prices actually dipped below prices of many mainland states, which historically had lower prices than Hawaii's. This pricing trend will occur again under our gas pricing law.

Moreover, Hawaii's prices will continue to fall as prices throughout rest of the country fall, but this may not happen quickly or uniformly because the gasoline market remains in a state of flux and continues to suffer from the disruption to the oil and gasoline production infrastructure caused by the hurricanes. Until refining capacity returns to 100%, we will not have a normal market in gasoline and the full benefits of our new law will not be apparent. When mainland markets return to a more typical price level, Hawaii will see its prices go even lower

It should also be emphasized that until the national gasoline market stabilizes, Hawaii will be susceptible to a perception of our prices being much higher than the mainland. In volatile markets, like those we are still experiencing, the fact that our prices lag those of the mainland by a week will create situations in which our prices can be going up while the mainland prices are falling. This is exactly what happened during the week of October 10. The price ceiling was set the previous week on October 5 and was based on the period the week before that when mainland prices were rising. However, by October 5, mainland prices had begun falling and continued falling throughout the remainder of that week and the week of October 10 when Hawaii's next set of prices went into effect. But these prices were based on a mainland peak price almost two weeks old. This staggering of prices resulted in Hawaii's prices rising at the same time mainland prices had already fallen and were continuing to fall quickly. The result, if you only looked at this one week, was a perception that our prices are much higher than the national average. Unless we change prices daily this perception will continue as long as the industry is recovering from the hurricanes and the market remains volatile. However, after the gas pricing law has been in effect for a few months, a moving average of the weekly price changes will show that our prices track more closely to the national average than many people believe.

Furthermore, no matter how we configure the price ceiling, our prices will be higher than a number of other states simply because Hawaii gas taxes are at least 18 cents per gallon higher than the national average. If we reduce some of the General Excise portion of the gasoline tax, we can reduce the overall cost of a gallon of gas.

In addition, the way the PUC formulated the price ceiling added quite a bit of potential cost to each gallon. The Oahu zone price, which the legislature intended to be zero, was set at $0.065/gallon, adding almost seven cents per gallon to the price ceiling. The PUC's own consultant, ICF Consulting, also recommended that in setting the zone price adjustments which allow wholesalers to charge additional amounts for the distribution (i.e., transportation) costs, those costs should be based on the average historical cost. Instead, the PUC used the highest historical cost for distribution in the price ceiling formula. The bottom line is that the PUC set the price ceiling higher than it should have been.

The oil companies also continue to gouge and price their products unnecessarily high. They buy cheaper oil than mainland refiners, yet they still sell their product for more than their mainland counterparts by pricing up to the ceiling -- far beyond the price necessary to realize a fair (and substantial) profit. We need to look at ways to bring the ceiling down further to reduce the profiteering.

Finally, the markets in the index used to set the gas price ceiling, as stated above, tend to be higher at times than other markets in the nation. The PUC's consultant indicated that we should re-evaluate the way the price ceiling is configured after it has been operating for a while and then make adjustments to reduce any excess pricing we find. We should conduct an analysis after the gasoline market returns to a more normal state and make needed adjustments in the areas discussed above, including re-examining the markets that make up the index. I believe a combination of adjustments can be made to greatly reduce the difference between the price of gas in Hawaii and the national average price.

To recap: what the Legislature should look at for next session is to consider reducing the GE portion of the gasoline tax, reconfiguring the PUC formula (eliminate Oahu Zone price adjustment and use average distribution cost), and re-examining the index used to set the price ceiling.

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GAS PRICE CAP

Facts show law is not flawed

It is a shame that Jack Suyderhoud ("Gas price cap broken, unfixable," Sept. 18) and Rep. Lynn Finnegan ("Cap is a bad idea that will bring us only more grief," Sept. 18) need to use speculation, flawed data and misrepresentation to convince Hawai'i consumers that the gas cap will not work. Let the people of Hawai'i decide this issue based on facts regarding the gasoline industry in Hawai'i.

Because of the catastrophic damage caused by Hurricane Katrina, there were dramatic price increases throughout the world, not just Hawai'i. Gasoline and crude oil are global commodities. They are affected by world events and no market can be isolated from a catastrophe such as Katrina.

For Suyderhoud and Finnegan to argue that gasoline prices in Hawai'i went up because of the gas cap law is totally false, irresponsible and contradictory to statements made by the president of Tesoro. President Bruce Smith said, "Prices would have gone up with or without Hawai'i's gas cap law." (the hawaiichannel.com, Sept. 12). He went on to say: "What we are currently experiencing is the market reacting to a severe supply disruption by increasing prices in order to attract needed supply."

Suyderhoud contends that only because of the gas cap law Hawai'i prices will be tied to Mainland markets. The fact is Hawai'i has been tied to the Mainland markets and world markets for decades. Hawai'i gasoline prices have spiked upward with the Gulf War (1991), California's change to CARB GAS (1996), the war in Iraq (2002), Hurricane Ivan (2004), the BP refinery explosion in Texas (2005) and Hurricane Katrina. How else could Hawai'i maintain its distinction of having the highest gas prices in the country if we didn't always go up in price when these events occurred? It should be noted that two of these events were in the Gulf Coast and none had any direct relation to the Hawai'i gasoline market.

Suyderhoud's criticism that the gas cap is only on the wholesale prices and retailers would be allowed to charge whatever they please has already been answered. The retail dealers have proven to be fierce competitors.

On Sept. 19, the independent dealers were the first to offer consumers some of the lowest retail prices for regular unleaded. Many independent dealers dropped retail prices as much as 53 cents in the morning. It must be remembered that unlike company-operated stations, independent dealers depend heavily on profits from their other profit centers (which can account for as much as 70 percent of their profit) such as stores and service bays. Dealers will sacrifice gas profits to gain customers. Suyderhoud's contention that there will be little competition at the retail level because of the gas cap law has already been debunked. It is obvious that Suyderhoud has very little knowledge about retailing.

Suyderhoud made a calculation as to what would have been *if* the gas cap were in place the "12 months before." His calculation requires "an estimated item" (the dealer margin). His "estimation" is far from what the actual dealer margin really was.

The critics of the gas cap law were frantically appealing to Hawai'i consumers during the Katrina catastrophe. The critics' biggest fear is that once the world gasoline price stabilizes, and the gas cap is accepted by Hawai'i consumers, speculation, flawed data and misrepresentations will no longer be able to convince consumers that the law is flawed.

HUGH OGBURN | Former senior VP, PRI Refinery

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RICHARD MILLER | Former dean, Richardson Law School

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FLAWED CRITICISM

Gas cap needs time to adjust

With all due respect to my good friend Jack Suyderhoud and others, the state's gas cap, flawed though it might be, is working. One simply has to look at all gas prices locally and compare them to the national prices to see that.

I spent a good portion of the last 20 years of my professional life traveling to the Mainland, where my work required that I rent cars and purchase gasoline. Until four or five years ago, the prices per gallon on the Mainland in any part for any grade of gasoline were always at least 30 cents, and often 40 cents or 50 cents, lower per gallon than the least expensive gas available in Hawai'i — and this despite the fact that crude oil came into our local refineries at prices quite comparable to its delivery price to West Coast and other refineries. It was only after the state began its efforts (not coincidentally, four to five years ago) to address this disparity by way of lawsuit and then legislation that the prices began to come into line with Mainland prices.

There is a clear cause-and-effect between the price adjustments that occurred and those efforts. The present criticism of the gas cap because of fluctuating prices is flawed for several reasons. First, the gas cap was never intended to rigorously regulate prices by setting fixed prices. Its intent and its effect is to assure that, over the long run, the prices in Hawai'i are comparable to Mainland prices. And it does that by regulating wholesale prices by comparing them to Mainland prices, since investigation showed that wholesale was where the markup was greatest and most unwarranted.

Because the Mainland as a whole is going through a very tumultuous time with much higher prices because of the effects of Hurricane Katrina and Rita, the gas cap necessarily reflects those higher prices. When that situation settles down and prices stabilize on the Mainland, so will our prices.

The second criticism — that the cap is inadequate because it does not regulate retail prices and stations are gouging the public — is easily answered. All one has to do is look at the various retailers to find that a significant portion of those stations in virtually every community are charging as much as 30 cents less per gallon than others for any grade of gas.

All an intelligent consumer has to do is choose to purchase at that lower-priced station. If we as consumers do that, we will force those retailers who try to gouge us to lower their prices and actually compete in the market.

The foregoing also addresses another flawed comparison that has been used to criticize the gas cap — namely, the use of the "average" retail price per gallon in Hawai'i as a basis for criticism and for comparison to Mainland prices. Because some stations are choosing to charge exorbitant prices, that "average" price is much higher than the lowest price of gas available. In evaluating our gas prices whether compared to the Mainland or otherwise, we should be looking at the lowest prices, since those stations are widely available to all Hawai'i consumers and are where we can and should be buying.

In short, the state Legislature has passed many silly, bad and ineffectual laws in its time, but the gas cap is not one of them. It may not be a perfect law, and it may need some adjustment, but we should wait and watch its effect over a much longer period of time and well beyond the current period of price instability on the Mainland before we contemplate such changes.

TED MEEKER | Kāne'ohe