May 25, 1999

Hon. Bill Lockyer
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Connie Lemus
Initiative Coordinator

Dear Attorney General Lockyer:

Pursuant to Elections Code Section 9005, we have reviewed the constitutional initiative entitled, "Motor Vehicle Fuel Utility Act of 2000" (File No. SA1999RF0017, Amendment #1-S). The measure: (1) requires voter approval for the deregulation of any existing utility; (2) designates entities engaged in the production and distribution of liquid motor vehicle fuel as utilities, subject to legislative control; and (3) imposes temporary regulations on fuel pricing and provides for the permanent regulation of the industry.

MAJOR PROVISIONS OF THE INITIATIVE

Deregulation of Existing Utilities

The State Constitution establishes that the operation of various industries are public utilities subject to control by the Legislature. This initiative requires that the deregulation of existing utilities could only occur through voter approval, instead of through legislative action, as is currently the case. The initiative does not define "deregulation," which may lead to ambiguities in the interpretation of this portion of the initiative. By some measures, for example, the power industry has been deregulated, although the industry is still subject to a certain degree of regulation. Given the lack of definition in the initiative regarding the meaning of deregulation, it is uncertain whether *any* changes resulting in a lessening of regulatory oversight (such as occurred with the power industry) would require voter approval, or only those actions which result in an industry free from *all* government oversight or control.

Regulation of the Motor Vehicle Fuel Industry

The initiative sets up a temporary mechanism—and establishes procedures for a permanent system—for the regulation by the Public Utilities Commission (PUC) of motor vehicle fuel corporations. These corporations are defined as every corporation or individual owning, controlling, operating, or managing any manufacturing, refining, distribution and/or retail establishment that sells, loans, or consigns combustible liquid fuels for use in powering land or water-based vehicles, including—but not limited to—gasoline and diesel fuel.

Temporary Provisions. For a two-year period (or less), the measure subjects the fuel industry to preestablished price regulations. For the purpose of establishing prices during this temporary period, the initiative defines three grades of gasoline and two grades of diesel fuel. The initial prices (including taxes) for gasoline are $1.01 per gallon (regular grade), $1.05 per gallon (medium grade), and $1.09 per gallon (premium grade). For diesel fuel, the initial prices (including taxes) are $1.01 per gallon (low grade) and $1.06 per gallon (high grade). Initial wholesale product prices are set at 14 cents below these amounts. Fuel grades not specified would have the wholesale price set at a level which ensures a "modest" profit. Other types of fuel used in motor vehicles (such as compressed natural gas) would also be regulated. During the temporary period, retail utilities owned by other oil utilities would be prevented from lowering their prices below the average prevailing price for the area; however, independent retail utilities could set prices below the established levels and the PUC could reduce the sale price at any time.

During this temporary period, the PUC is directed to establish the Motor Vehicle Fuel Regulatory Council (the "Council"), comprised of representatives of the fuel industry. The Council is to act as a representative of the utilities before the PUC, and as a liaison between the utilities and the PUC. After one year has elapsed following the passage of the initiative, a permanent Council is to be formed consisting of representatives from manufacturers, refiners, distributors, and retailers of the motor vehicle fuel industry. Member utilities would pay dues (which will include costs associated with regulating the industry) to the Council in amounts that are "reflective" of their individual positions in the industry.

During the temporary period, no more than two price increases per calendar year could be granted and applied to the wholesale price or retail price or both, with the total amount of each increase not to exceed 4 cents. Additional increases could be granted in order to compensate the utilities for the costs of complying with any new state laws or regulations. The burden of proof necessary to grant any increase would lie with the Council. Price reductions are to occur when conditions that caused an increase in prices cease to exist. The initiative prevents the levying of additional fees on retail or wholesale sales.

Permanent Regulation. Within two years of the passage of the initiative, the PUC and the Council are required to formulate legislation regarding the regulation of the utilities for submission to the Legislature for consideration. The legislation is to contain elements which:

- Establish a base price for fuels (equal to the price at which fuel is being sold when the legislation is passed).
- Establish rules for price changes, including the number of changes that may be granted each year.
- Require the "divorcement" of fuel manufacturers, refiners, and distributors from fuel retailers.
- Provide for recouping the costs of regulation, require periodic audits of the Council and the utilities, and establish fines for noncompliance with laws and regulations.
- Allow for the protection of the utilities during divorcement, and appoint a public advocate to represent the public in all hearings before the Legislature, PUC, or other official bodies, regarding the regulation of the utilities.

Administrative and Legal Issues

Regulated Fuels. The initiative specifies that it is intended to regulate fuel used by land-based and water-based vehicles, but it is not clear whether or not airplane fuel is regulated, since it is unclear whether airplanes are land-based vehicles. In addition, it is not apparent (1) whether fuels not currently used for vehicular purposes would be subjected to price regulation if they were used in vehicles in the future, and (2) if the fuel regulations are to apply to motor vehicle fuel in general or only when it is used in a motor vehicle.

Preestablished Prices. The 14 cents differential between the wholesale and retail price during the temporary period is insufficient to cover state and federal taxes and provide a reasonable rate of return for fuel retailers, unless wholesale prices include taxes. While the PUC would have the discretion to adjust fuel prices (wholesale or retail), the measure limits the frequency and magnitude of these adjustments during the initial two-year period, placing an upper bound on any increases.

Price Adjustments. There remains some ambiguity regarding price changes that can occur under the measure. According to the initiative, these are limited to two times per year in an amount not to exceed 4 cents per gallon (except if costs are increased through state regulation or legislation). However, the initiative also suggests that this limitation is temporary, since one of the charges given to the Council and the PUC is to establish rules regarding the frequency and magnitude of price increases. Also, given that the initiative states that the burden of proof for justifying price increases lies with the Council, it is not clear whether absent this presentation of proof, the PUC may choose to adjust prices of its own accord.

Other Fees. The initiative indicates that no additional fees will be charged for the sale of wholesale and retail fuels. However, clarification would be needed as to whether this would limit the ability of wholesalers or retailers to charge other types of fees associated with but not directly linked to fuel sales (fees to access service stations, for example).

Legal Issues. If a reasonable rate of return is not allowed (as discussed above), the initiative runs the risk of what is considered an illegal "taking" of property, in which case the initiative would likely be challenged in court.

FISCAL EFFECTS OF THE INITIATIVE

State and Local Revenue Impacts

Temporary Regulation Period. During the temporary period, the limitation on the frequency and magnitude of price increases could result in regulated prices below prevailing market prices. Under the most likely scenario, this would lead to supply restrictions because of the inability of fuel utilities to operate profitably. These shortages, in turn, would result in reductions in fuel excise tax revenues and reductions in sales tax revenues to state and local governments. If shortages occurred with sufficient severity, there would also be declines in economic activity, resulting in reductions in various state and local revenues. The total annual loss in government revenues could be in excess of $1 billion.

If, on the other hand, the industry continued to provide adequate fuel supplies (due to their ability to earn a reasonable rate of return even at below-market prices), the fiscal impact would differ significantly. There would be a decline in sales tax revenues and increases in excise tax revenues (the latter due to additional fuel consumption resulting from lower fuel prices). Reduced fuel costs also would generate increased economic activity, resulting in increased state and local revenues.

Permanent Regulation Period. Most of the specifics for regulation of the industry after the two-year period are left to future legislation. If appropriate price regulations were adopted, an adequate supply of fuel could be supplied with a fair return to fuel utilities. In this case, the measure would not have significant impacts relative to existing law. If average rates of return to the industry are currently higher than “normal,” even prices set below the market price might accommodate competitive rates of return to the industry and result in no supply shortages. However, under different assumptions, and depending upon industry structure and behavior, prices set below current market rates could cause fuel shortages, resulting in fiscal effects similar to those outlined above.

The purpose and intent of the initiative is to provide customers with fuel at a reasonable, fair, and reliable rate, “regardless of market conditions.” The relative weight to be given to each of these objectives is not specified, however, and they may come into conflict. Ensuring a reliable rate may require that the utilities purchase “forward contracts” or maintain a reserve inventory in order to ensure a constant supply of fuel. These steps would also lead to an overall increase in utility costs, possibly resulting in prices higher than might otherwise have occurred.

The process of divorcement required in the initiative calls for the separation of the manufacturing, refining, and distribution segments of the industry from the retail segment. To the extent that there are economies of scope or scale achieved by vertical integration in the industry, this process of divorcement could result in higher costs for the industry than would occur without such separation, and which could be reflected in higher fuel prices. This could result in reduced overall economic activity and a decline in state and local revenues of unknown magnitude.

State Administrative Costs. Transition costs associated with establishing a new regulatory apparatus and procedures would result in state administrative costs in the tens of millions of dollars. In addition, maintaining the associated regulatory and enforcement capabilities of the PUC could result in ongoing annual costs in the high tens of millions of dollars.

SUMMARY

The measure would have the following major impacts on state and local government revenues:

- ***Initial Two Years.*** Unknown effect depending on the economic impacts of the fuel price restrictions. If, however, the measure resulted in fuel supply shortages, there could be annual revenue reductions in excess of $1 billion.

- ***Long Term.*** Unknown net effects on state and local revenues, depending on the manner in which the fuel industry was regulated.

Sincerely,

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Legislative Analyst

B. Timothy Gage
Director of Finance