January 18, 2005

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

Attention: Ms. Tricia Knight
Initiative Coordinator

Dear Attorney General Lockyer:

Pursuant to Elections Code Section 9005, we have reviewed the proposed initiative (File No. SA2004RF0036), creating the California Petroleum Commission.

Background

There are currently 23 petroleum refineries operating in the state, along with various storage facilities that store the product before it is delivered to a refinery for processing; about 60 terminals that store the finished fuel products prior to delivery; and a number of petroleum product pipelines. The refineries and storage and delivery infrastructure are owned by a relatively small number of companies.

Currently, the petroleum refineries and related infrastructure are subject to a number of permitting requirements, including state and federal environmental permitting requirements and local land use permitting requirements. However, there are currently no requirements that these facilities be licensed by a governmental regulatory body charged specifically with licensing petroleum facilities. In addition, there is currently no price regulation of the petroleum industry in the state by a governmental entity.

Proposal

Powers and Duties of a New California Petroleum Commission. This initiative creates the California Petroleum Commission as a new state agency to regulate privately owned petroleum companies doing business in the state. The initiative prescribes the membership of the commission (three members appointed by the Governor and four members elected at statewide elections) as well as the powers and duties of the new commission. These powers and duties include various regulatory-related functions as well as policy, planning, and other duties, as described below.

The regulatory-related functions include the following:

- ***Rate-Setting.*** The commission is required to establish maximum "rates" for each fuel produced from petroleum that is sold in the state, in a manner that limits petroleum business profits to a prescribed cap. ("Cumulative profit" is limited to not more than 5 percent over "costs.") Although not stated explicitly in the measure, it appears that the intent is for the commission to set rates at the wholesale level, rather than the retail level. More specifically, it appears that the commission would set the wholesale prices of "producers," who are defined in the measure to include refiners and blenders of petroleum fuel for sale in the state.
- ***Licensing.*** The commission is required to license petroleum producers and petroleum facilities, as defined in the measure.
- ***Forum for Consumer Complaints.*** The commission is required to provide a forum for consumer complaints about the petroleum industry.
- ***Control of Marketing Arrangements and Practices.*** The commission is authorized to order producers to modify marketing arrangements or practices that are determined to have an adverse impact on fuel price and supply.
- ***Standard-Setting and Rule-Making***. Finally, the commission is authorized to establish "service standards and rules governing the petroleum industry."

The policy, planning, and other duties include the following:

- ***Supply-Related Needs Assessment.*** The commission is required to assess the need for additional petroleum facilities to supply the California market, and is authorized to require a producer to construct additional facilities as a condition of receiving a license.
- ***Promotion of Alternatives to Petroleum Products.*** The commission is required to promote the use of alternatives to petroleum products.

Funding of Commission's Operations. The initiative provides that funding for the commission's operations shall be provided in the annual budget act. The initiative provides a funding source for only one component of the commission's operations. Specifically, the commission is required to establish licensing fees for its licensing-related functions.

Fiscal Effect

State Costs to Implement Measure. The measure would result in state costs to establish and operate the new California Petroleum Commission based on the regulatory and other program functions required to be carried out by the commission.

The annual costs to operate the commission are unknown, but could be in the tens of millions of dollars, up to about $40 million. Under the measure, any costs associated with the commission's licensing function are to be covered by fees. Accordingly, up to about $6 million of the estimated costs would be offset by fee revenues.

Uncertain Impact on State and Local Revenues. The fiscal impact of the measure on state and local revenues is uncertain. In practice, the history of price regulation as implemented has shown that it has in many cases distorted markets, causing supply-demand imbalances, reduced investment, and other problems. The specific impact of this measure would depend on the interpretation of a number of the measure's provisions, the varying impact of the measure's requirements on individual petroleum producers, and future market conditions of the petroleum industry.

First, the fiscal impact of the measure's rate-setting and other requirements on petroleum producers, and ultimately on state and local revenues, would depend on the interpretation of a number of the measure's provisions that are not defined. For example, the measure does not define producer "costs" or "cumulative profits," which are two variables in the rate-setting methodology prescribed by the measure to be applied by the commission.

Second, the fiscal impact of the measure's rate-setting and other requirements would also vary among petroleum producers, with differing impacts on state and local revenues. For example, to the extent that the measure's rate-setting requirements result in a producer receiving a rate of return that is lower than would otherwise be the case under current law, the measure could discourage investment in petroleum facilities, and potentially petroleum production, by that producer in the state. To the extent that this occurs, there would be state and local revenue losses due to reduced revenue from corporate and personal income taxes, property taxes, and gasoline excise taxes. Alternatively, if the rate-setting mechanism reduces wholesale petroleum prices, without reducing production and investment, consumers in the state could benefit in the form of lower retail prices. Such a benefit to consumers could increase the level of economic activity in the state, resulting in increased state and local government revenues of an unknown amount.

Finally, the impacts of the measure on individual petroleum producers over the long term would also depend on the market conditions of the petroleum industry existing at any particular point in time. Such future market conditions are unknown. Accordingly, the measure's long-term impact on state and local revenues due to economic changes is unknown.

Summary

In summary, the initiative would have the following fiscal effects:

- Annual state costs, potentially in the tens of millions of dollars, up to about $40 million, for regulatory, planning, and other activities of the California Petroleum Commission, a state agency created by the measure. These costs would be partially offset by fee revenues.
- Unknown net fiscal impact, but potential reductions in state and local revenues to the extent that petroleum price regulation results in decreases in profits and possibly petroleum availability, investment, and economic activity generally. These reductions would be potentially offset, to an unknown extent, by revenue increases resulting from increased economic activity generated by lower retail petroleum prices to consumers.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Tom Campbell
Director of Finance