Perspectives On Gas Prices

State to Blame for Gas Price Rise - California isolated by its regulations on air quality
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CALIFORNIANS ARE understandably wondering why gasoline prices have risen by about 40 cents a gallon since March.

Bill Lockyer, California's attorney general, is investigating the oil companies for price-gouging and U.S. Senator Barbara Boxer has asked the Federal Trade Commission to look into possible collusion among them.

But they can save their time and our money. The main cause of the price increase is a reduction in supply due to two fires at California oil refineries, combined with government regulation that isolates the state's gasoline market from the rest of the nation's.

Fluctuation in world oil prices and oil companies' pure and simple greed are two popular assumptions for explaining the leap in state oil prices, but neither is correct.

World oil prices can be eliminated from the get-go. The reason: During the time gas prices increased by more than 40 cents a gallon, the world price of oil increased by about $3 a barrel. At 42 gallons to the barrel, this $3 rise translates into about 7 cents a gallon. That isn't quite exact, because a barrel of oil doesn't produce 42 gallons of gasoline; only about 30 percent goes to gasoline -- the rest goes to other petroleum products. But the point is that crude oil prices are only a small part of the story.

What about the other 30 or so cents? First, note that the price increase occurred only in California, another fact that eliminates world oil prices as the culprit. Some believe the blame can be laid on the greed of California refiners. California refiners are greedy; they, like the rest of us, are trying to do as well for themselves as they can. But aren't refiners in the rest of the United States just as greedy?

Moreover, why did California refiners suddenly get greedier in the last three months? Can't we assume that, whatever their level of greed, they've been that way for quite a while?

So what changed in California that didn't change in the rest of the United States? The answer is the amount of gasoline produced in California.

According to the American Petroleum Institute in Washington, gasoline production was down from 953,000 barrels a day in March 1998 to 880,000 barrels a day in March 1999, a reduction of 7 percent. The main reason for this reduction is the recent fires at two California refineries, one at the Tosco refinery in Avon on February 23 and the other at Chevron's Richmond refinery on March 25. How could a 7 percent reduction lead to about a 25 percent increase in price? The answer is what economists call ``inelastic demand.'' Translation: When the supply falls a little, the price has to rise to cause us to cut the amount we buy down to what's available.

Still, there's a puzzle left to explain. Ordinarily, when the price of a commodity rises in one region and that com modity is easy to ship from another region, people called arbitrageurs make money by buying where it's low and selling where its high. The arbitrageurs' increased shipments drive down the price in the high-price region. But that hasn't happened in California.

The reason is that because of regulation by the California Air Quality Board, gas sold here must meet stricter standards than gas sold in Nevada or Oregon, even though air quality outside of the Los Angeles basin is comparable to air quality in other states.

In short, arbitrageurs can't sell readily available gasoline from nearby states to California because such gasoline can't be legally sold here. Retooling costs for refiners in other states to produce California-legal gasoline are too high to make it worthwhile for the short time that we Californians must live with the price increase.

California's government has unwittingly isolated its market from the rest of the country. Its air-quality regulations, not oil companies, are the cause of the higher

prices. Many people are tempted to advocate price controls to reduce the prices we pay at the pump. Been there, done that. Price controls were what caused the U.S. gasoline shortages in 1973 and 1979. Switzerland and other countries that produced no oil but whose governments allowed gasoline prices to adjust fully to higher world oil prices went through the 1970s with no gasoline shortages.

The high gasoline prices we are paying now are outrageous. But let's be clear on who is perpetrating the outrage. It's California's government. All Californians are paying a very high price for very small increases in air quality in the Los Angeles Basin.

While the two California refineries are down, the only way to lower gas prices and still avoid line-ups is to get the government to relax the regulations outside the Los Angeles area.