Act 77 Study Report
September 2003
Conclusions and Recommendations

Conclusions:

1. **Hawaii's Gasoline Market.** Hawaii's gasoline market is not perfect, but it is not "broken". The market is concentrated, but Aloha Petroleum has leveraged its capability to import through its terminal into local supply contracts at import parity. Other non-refining marketers now also have access to gasoline at prices close to import parity. At the retail level, dealers operate in a highly competitive environment. Market inefficiencies, with high costs and less than vigorous competition, occur between the wholesale and retail level. In addition some Neighbor Islands are impacted by logistical bottlenecks that further impair competition and cost effectiveness. Maui and West Hawaii are examples where infrastructure is an issue to market entry.
2. **Refinery Profitability.** Hawaii refiners have primarily low margin product slates – jet fuel and residual fuel oil for power generation. The products are sold to large customers with market leverage. Hawaii refiners compensate with higher gasoline prices, but although they can be more profitable than Mainland refineries, they do not make excessive profits[1].
3. **Retail Profitability.** On average, Hawaii's retail station sales volumes are only about half of typical Mainland stations. Moreover, Hawaii dealers incur higher real estate costs, taxes, and other overheads. Several other factors contribute to Hawaii's high gasoline prices, such as Hawaii's State fuel tax, which is 12.5 cpg higher than the national average.
4. **Price Caps.** An analysis of gasoline price caps in general, and those enacted in certain parts of Canada in particular, shows that these measures generally are ineffective, risky, costly, open to manipulation, and complicated to administer. It is likely that likewise the caps in Act 77 would fail to achieve their objective of protecting the interests of gasoline consumers. Analysis of historical data shows that the statewide average prices for Hawaii gasoline consumers would have been higher with caps than without. Moreover, the current price cap formula would introduce California's price volatility and seasonality into Hawaii's gasoline prices.
5. **Other Policy Aspects.** In general, the State's policies with regard to the gasoline industry have not fulfilled their stated intent. The divorcement and lease rent cap regulations have not been effective in protecting dealers, and both divorcement and lease rent caps were found to raise consumer gasoline prices. For example, an FTC study of divorcement policies in six states (including Hawaii) and D.C., concluded divorcement raised the price of regular unleaded gasoline by about 2.7¢ per gallon. These policies also project an anti-business image.

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[1] Dr. Keith Leffler, one of the State's expert witnesses in *Anzai v. Chevron, et al.*, in memo to AG wrote: "*the refineries in Hawaii do not earn a profit or income disproportionate to that earned by refineries in California."* Dr. Keith B. Leffler, *Analysis of Hawaii Refinery Prices and Margins*, March 4 1995, pp. 8. See Stillwater report, p. 50.

6. **Industry Reporting.** The State's current petroleum industry data reporting policy (Chapter 486J, HRS) is intended to provide market transparency. However this objective has not been achieved, nor will it be able to succeed without adequate resources and fine-tuning of the policy. If done right, monitoring of prices and volumes, analysis of data, and reporting of aggregate results to the public, are more effective than price caps. Data can uncover market irregularities, and illegal or suspect activity could be reported to enforcement agencies. This kind of information can also help detect bottlenecks in the market. Then, market-based approaches could be developed to help increase competition. For example, policies to encourage or facilitate infrastructure development for market access by competitors. Monitoring and oversight is far less complicated to administer than price caps. Additional resources will be needed, but monitoring and oversight costs less than *half* of the price controls and regulatory requirements mandated by Act 77.
7. **Petroleum Commissioner.** The role and functions of the Petroleum Commissioner as created by Act 77 are inconsistent with DBEDT's mission, and redundant of those of other State agencies.
8. **Direct State Intervention.** Lower consumer prices would not automatically result from a State operated non-profit import terminal, as has been proposed in the past. Import parity prices could be achieved by government intervention, but not without significant risks to Hawaii's petroleum industry, the economy, and the consumer. For example, a state-owned terminal and distribution system needed to achieve import parity gasoline prices would likely force closure of one if not both refineries. If both closed, the loss to the economy is estimated at 1,400 jobs – 0.2% of Hawaii's total workforce – and $405 million/year of economic contribution.
9. **Integrated Energy Strategy.** The report concluded that the realization of an integrated state energy strategy could be an effective way to lower the State's high energy cost structure. The strategy should consider renewable energy, energy efficiency, hydrogen energy, and alternative fuels. It could factor issues facing Hawaii's petroleum and other energy industries. The aim should be energy and economic efficiencies, diversification, and sustainability.
10. **Consumer Education.** Industry could benefit by educating consumers on details of the business from production to retail sales. Additionally, consumers need to make better-informed decisions about required octane levels, and buy their gasoline on a comparative price basis. Consumer education by government and industry could help save millions of dollars, if consumers act on this advice (appropriate octane use could save Hawaii consumers over $7 million/year; comparative price shopping could save up to 20¢/gallon).

Recommendations:

Based on its conclusions and the Act 77 mandate, the Team developed two types of recommendations – those requiring legislation to implement and those that do not.

<u>Legislative recommendations include the following components</u>:

1. <u>Repeal gasoline price caps</u>.
2. <u>Eliminate the State Petroleum Commissioner's role</u> and revert relevant petroleum industry data functions to DBEDT Director as contained in the statute prior to Act 77.
3. <u>Repeal the divorcement law</u> that restricts conversion of dealer-operated stations (lessee stations) to company-operated stations by refiners and wholesalers; and repeal the geographic restrictions on building retail service stations by refiners and wholesalers.

4. Repeal the lease rent caps on all leases as part of a franchise on dealer-operated stations, and the restriction on the frequency of the lease renewal.
5. Repeal DBEDT's extensive petroleum industry regulatory functions; e.g., random and periodic company audit and inspection requirements.
6. Revise existing petroleum industry data reporting requirements to provide market transparency, and provide adequate implementation funding. Collect price and volumes data in detail on all products and all classes and levels of trade. This data can be turned into information that can be used by enforcement agencies, if warranted. Also, equipped with reliable price information consumers can make more informed purchase decisions.

   Funding is essential to support the positions and operating budget.
7. Potentially require that industry post octane "buy smart" labels on pumps.

Recommendations not requiring legislative action:

8. Encourage industry to do a better job of reconciling the study results with public perceptions. There is a need to educate consumers on details of the business from production to retail sales.
9. Conduct consumer education by government, which has the potential to help save approximately $7.9 million consumers' dollars/year. Also, call on industry to participate in consumer education partnership, potentially avoiding a requirement to post octane "buy smart" labels on pumps (Recommendation 7, above).

Stillwater Associates LLC is a management consulting firm in the energy sector. Its main focus is on the downstream segment of the oil industry, including marketing, refining and logistics. Other clients include the Energy Information Administration of the U.S. Department of Energy, the California Energy Commission and many private sector energy firms. The team members that contributed to the Hawaii Fuel Study were Anthony Finizza PhD, Thomas Gieskes, David Hackett, Gregg Haggquist, and Joseph Monfiletto. The September 8, 2003, public briefing is conducted by David Hackett and Thomas Gieskes.