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*The price spike in the Spring of 2006*

# Why gasoline prices are headed for \$3.50 at the pump



Commissioned By:

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## Introduction

In 2005, gasoline pump prices and profits for oil companies both set all time records. By January 2006, prices at the pump declined from the post-Katrina record highs, but by April, 2006 pump prices spiked again across the country and media reports that 2006 pump prices would continue rising nationally above \$3 per gallon. Some industry analysts predicted prices of up to \$4 per gallon in the event of refinery disruptions.

The oil industry blamed three factors:

1. The skyrocketing world price of crude oil – which exceeded \$70 per barrel on the volatile spot market;
2. Manufacturing costs of reformulating gasoline blends for cleaner burning fuels;
3. The switch across much of the nation to ethanol as a pollution-control additive, replacing MTBE as the oxygenate of choice.

The Foundation For Taxpayers and Consumer Rights turned to Petroleum Industry Consultant Tim Hamilton for an analysis of the causes of the 2006 price spike, particularly as it affects California. Mr. Hamilton's report, in detail below, shows that contrary to what oil companies argue, most of the leap in pump prices is corporate markup, not factors outside producers' control.

## Executive Summary

The California average pump price for regular unleaded gasoline was \$2.21 per gallon on January 03, 2006<sup>1</sup>. By April 10, 2006, the average price jumped 60 cents per gallon to \$2.81 and continues to rise. On behalf of FTCR, Mr. Hamilton examined industry and public data — including data compiled by the California Energy Commission, State Board of Equalization, the federal Energy Information Administration (EIA) and the U.S. Department of Transportation—to identify causes of the increase at the pump.

The main findings of the 60-cent price spike from January 03 through April 10 are:

- Increases in the “spot” market price of crude oil – which is the highest price a major oil company would pay for crude oil — accounted for only 12 cents per gallon<sup>2</sup>. California's percentage sales tax increased fuel prices by another four cents per gallon<sup>3</sup>. Approximately 42 cents (variation due to rounding) of the 60-cent increase in gasoline prices is attributable to increased refinery and marketing profit margins for the oil companies;

- Neither the MTBE phaseout nor the substitution of ethanol is a serious part of the increase. If the MTBE phaseout or ethanol blending increased costs for oil companies in California, other states in the West using conventional unblended gasoline should be much less affected. Washington State uses only conventional gasoline and Puget Sound contains the largest refining capacity in the West outside California. The average pump price for regular unleaded in Washington climbed 52 cents from \$2.15 on January 2 to \$2.67 on April 10— nearly mirroring California's rise. When adjusted for nine-cent-lower taxes in

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<sup>1</sup> Data Source: EIA, regular unleaded including all taxes

<sup>2</sup> Data Source: EIA, Henry Hub for West Texas Intermediate (WTI)

<sup>3</sup> CA sales tax varies, estimate used is 8 percent of the pump price

Washington, the gasoline price rise in the two states differs by only five cents per gallon, which is likely the impact of greater competition in conventional fuel than found in California’s unique CARB fuel or other local factors such as the lower costs of operating gas stations in Washington; and

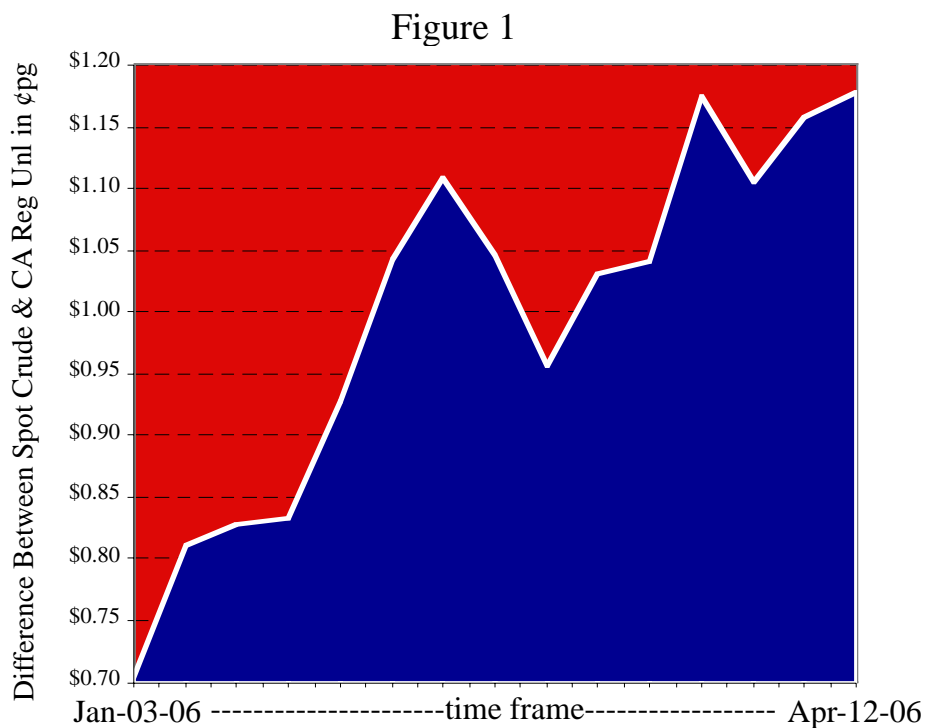
- The profit increase of 42 cents, on top of record profits last year, means California gasoline will cost consumers approximately \$546 million<sup>4</sup> more in April 2006 than in April of last year.

### The gap between crude and the pump price in California

Most of the crude oil purchased by refiners in the West is bought at a “contract” price – a stable price established in advance by the oil refiners. Many refiners harvest their own crude as well. The contract price is significantly less than the volatile and speculative spot market price so publicized by the media. As a result, using the spot market price for crude oil to determine the difference between crude costs and gasoline at the pump presents a conservative picture of the profit margins earned by California refiners. The analysis below, therefore, presents a conservative estimate of the industry’s profit margins.

According to the EIA, the spot market price of crude was \$63.38 per barrel or \$1.51 per gallon on January 6, 2006. The spot price increased by 12 cents per gallon by gradually climbing to \$68.62 or \$1.63 cents per gallon on April 12, 2006.

If the pump price of gasoline in California climbed in direct correlation with the increase in crude costs, the differential between crude costs and pump prices would remain relatively unchanged. In 2006, the differential rose from 70 cents per gallon in the first week of January to \$1.18 cents per gallon on April 12th (Figure 1). Pump prices climbed 48 cents per gallon more than the most generous estimate of the increased price of crude oil for refiners.



<sup>4</sup> April 2006 consumption estimate based on tax collections posted by the State Board Of Equalization.

## Adjusting for California’s sales tax at the pump

The state and local governments in California collect approximately 8% retail sales tax on the pump price of gasoline<sup>5</sup>. Since the amount of tax collection will increase with the pump price, the differential needs to be adjusted for the changes in gasoline tax collection.

Table one shows the effect of the sales tax on the pump price in California for regular unleaded as the price spiked. Converted to cents per gallon, the sales tax collection climbed from approximately 18 cents to 22 cents.

The price of regular unleaded, after subtracting the sales tax, climbed 55 cents per gallon by April 10, 2006. During the same period, crude oil only rose by 12 cents per gallon for a combined increase of 16 cents per gallon in increased crude costs and state taxes. Adjusted for the rise in state sales tax and the rise in the spot price of gasoline, the refining and marketing margin of the oil companies inflated by approximately 42 cents per gallon during the same period.

Table 1

Date	Crude	Tax/Gal	Pump Minus Tax	*Difference
2-Jan	\$1.51	\$0.18	\$2.04	\$0.53
9-Jan	\$1.52	\$0.19	\$2.14	\$0.62
16-Jan	\$1.59	\$0.19	\$2.22	\$0.63
23-Jan	\$1.59	\$0.19	\$2.23	\$0.64
30-Jan	\$1.59	\$0.20	\$2.31	\$0.73
6-Feb	\$1.50	\$0.20	\$2.34	\$0.84
13-Feb	\$1.41	\$0.20	\$2.32	\$0.91
20-Feb	\$1.43	\$0.20	\$2.28	\$0.85
27-Feb	\$1.48	\$0.20	\$2.24	\$0.76
6-Mar	\$1.45	\$0.20	\$2.28	\$0.83
13-Mar	\$1.49	\$0.20	\$2.33	\$0.84
20-Mar	\$1.46	\$0.21	\$2.42	\$0.96
27-Mar	\$1.56	\$0.21	\$2.46	\$0.89
3-Apr	\$1.58	\$0.22	\$2.52	\$0.94
10-Apr	\$1.63	\$0.22	\$2.59	\$0.95

\* Difference between the pump price less tax and the spot crude price Source: EIA

The 42 cents per gallon increase in the differential over 3 1/2 months is significant in California,—the largest motor fuel consumer in the nation. When multiplied by the 1.3 billion gallons of motor fuel<sup>6</sup> Californians used during April of last year, the profit increase for oil companies can be estimated conservatively at \$546 million in additional industry profits during April 2006 over April 2005.

## The price spike cannot be blamed on ethanol or the phaseout of MTBE

To account for the higher gasoline prices of late, oil industry representatives have consistently pointed to reformulated gasoline blends and the phaseout of the additive MTBE in favor of more environmentally friendly ethanol even though ethanol has consentantly sold for less than gasoline. A “like-for-like” comparison between neighboring states with similar crude supplies, refineries, and marketing companies yet different fuel blends should show differences in the cost of refining and marketing one blend over the other.

<sup>5</sup> The sales tax varies dues to minor differences in local government rates

<sup>6</sup> On road taxable consumption of gasoline and diesel only as posted by the CEC

Table 2

Mitigating Factors	California	Washington
Refining Center with seaport terminals	Yes	Yes
Majority of crude from CA or AK	Yes	Yes
Reformulated Gasoline	Yes	No
Ethanol or MTBE Blending	Yes	No
Price Increase Jan-April exc. sales tax	56¢	52¢

Table 2 above shows the similarities between California and Washington State. Both have large refining centers with seaport terminals. The refineries are primarily supplied by domestic crude from fields in Alaska and California. Gasoline refined in Washington helps supply California, and California refineries ship fuel to the Northwest. The primary difference is that California blends ethanol into reformulated clean-air “CARB” gasoline while Washington uses unblended conventional gasoline.

A reliable way to determine the impact of factors other than crude oil on gasoline prices is to compare pump prices in California with those in Washington State. Both states are refining centers of the West and are supplied primarily from the same domestic oil fields. While ethanol is mandated for reformulated CARB gasoline in California, conventional fuel without either MTBE or ethanol dominates in Washington.

Figure 2 below tracks the price of conventional regular unleaded in Washington and CARB ethanol blended regular in California during the month of April since the 2004 switch from MTBE to ethanol. The prices shown include all taxes. California’s state and local taxes are approximately 9 cents higher than Washington’s.

The increase in the pump price of non-blended conventional gasoline in Washington from April 2004 to this April actually exceeded the increase in California by 14 cents per gallon, despite California’s introduction of ethanol. The author believes one cannot blame the 2006 price spike on either reformulated fuels or ethanol producers. Rather, the primary factor in the price spike in the spring of 2006 is greatly enhanced refining and marketing profits, on top of the record-setting profit levels of the previous year.

