Breaking Down Prop 87

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Introduction

California's Proposition 87 promises to reduce oil consumption in California, at no expense to the consumer. I am quite sympathetic to the goal of reducing petroleum dependence. This is a goal to which we should all aspire. But I have my doubts that the promises being made by the Proposition 87 campaign can be kept. I also dispute many of the claims made by the Prop 87 proponents. Finally, I have a problem with the way the oil industry is being portrayed in order to win support for this measure.

[editor's note, by Prof. Goose] Don't forget the reddit and digg tip jars if you enjoy the piece.

While I do not intend for this to be a point by point rebuttal of Ana Unruh Cohen's recent essay in support of Prop 87, I do intend for it to debunk a number of claims from the Yes on 87 campaign. As I turn a critical eye toward the claims of the pro-87 contingent, I invite Ana to do the same to the anti-87 contingent if she wishes to write a follow-up to this essay. It is not actually my intent to argue that you should vote one way or the other, even though it may sound like I am staking out a solid No on 87 position. My intent in this essay is to look into my crystal ball to see what Prop 87 will really do, and to set the record straight with respect to the oil industry. My prediction is that Prop 87 will receive at least 60% of the vote, but that 10 years from now California will still be just as dependent on oil as is the rest of the country.

Where I'm Coming From

I struggled with whether to put this section at the beginning or the end. Ultimately, I decided to open up with it, because I want you to know up front where I am coming from. You may consider this section a personal rant, designed to explain why I get upset with some of the rhetoric that is directed at my industry. I understand that this rhetoric plays well in Peoria, and everywhere else for that matter, but as an oil company employee I feel that this is unfair to a great many people.

Many people think of oil companies and see the face of Lee Raymond, ExxonMobil's recently retired CEO. I see the faces of the many men and women who work very hard to make sure the transportation industry can get the fuel they need to deliver food around the globe. I see the faces of many people who juggled operations to make sure that the airplanes recently used to fight fires in Montana and Washington had the aviation fuel they needed to do their jobs.

I admit that my views are shaped from working inside the oil industry. But that doesn't mean that my views are wrong. When people write that oil companies are evil incarnate, they aren't just talking about Lee Raymond. In fact, they are talking mostly about people like Tim Crank. Let me tell you about Tim. Three years ago, Tim was working on a pump at a refinery in Ponca City, Oklahoma. A release occurred while he was working, which resulted in an explosion and fire. Tim died from injuries received as a result of the fire, leaving behind a wife and two young children. This tragic incident will always be imprinted in my mind, because I witnessed it. I know how his family struggled to cope with his death. Furthermore, I know that just about everyone in this industry can tell a similar tragic story.

While some may see this personal story as a cynical or insincere ploy to generate sympathy, the reason I told this story is to let you know why I get angry when my entire industry is characterized in venomous terms. The vast majority of oil companies are made up of people like Tim Crank, just trying to do their jobs, and tragically sometimes losing their lives in the process. People outside the oil industry often view us with disdain, because they think of Big Oil and see Lee Raymond. I get defensive because I see Tim Crank, out there working to make sure the public gets their fix of cheap gas. That's why I won't sit idly by while people speak of my industry with contempt. The Prop 87 campaign has been guilty of this, and this is why they have my undivided attention.

Fact or Fiction?

One of my biggest pet peeves has to be misleading claims or fiction that masquerades as fact. Following are some examples from the "Key Facts" page at the Yes on 87 site.

Yes on 87 "Fact": *Oil companies that oppose Prop 87 posted record-setting profits in the last five consecutive quarters -- $78.3B in 2005 and $20.5B in the first quarter alone of this year.*

Reality: Oil companies have in fact done very well lately. The oil industry is cyclical, and the current 10% earnings on sales is much better than the historical 5-7% earnings on sales. Of course these numbers pale in comparison to companies like Microsoft, who are earning 26.5% on sales. Microsoft recently had profits of $2.89 billion on revenues of $10.9 billion. Oil companies would love to see those kinds of margins. The overall numbers are larger for many oil companies, simply because the companies are much, much larger even than Microsoft. But record-setting profits are pretty meaningless unless placed in context.

Yes on 87 "Fact": *CA is the third largest oil-producing state, but the only one where the oil companies don't pay oil drilling fees like they do in other states.*

Reality: This claim is false. There are a number of states in which no drilling fees are paid. Furthermore, according to this article:

> Except for California, most oil producing states rely on a severance tax for the majority of oil revenues. Yet contrary to popular belief, California does not place an abnormally light tax burden on crude oil producers. Considering both tax and royalty revenues, state government revenues from oil production in California amounted to 13.4 percent of the value of nonfederal production in the state, well above comparable rates for Oklahoma, Texas, and Wyoming.

Yes on 87 "Fact": *Oil companies are gouging California consumers at the pumps with the highest prices in the nation.*

Reality: As you will learn in this essay, the reason Californians pay some of the highest gas prices in the nation is that they have some of the highest gasoline taxes in the nation. Besides that, I dispute that anyone is being gouged. First, provide a definition of "gouging", and then I will get back with you on that one. I suspect we would find that pretty much anyone who sells into a rising market would be guilty of the same kind of gouging. Most people in California who have sold a home at a nice profit would certainly be guilty of gouging.

Yes on 87 "Fact": *Oil companies are blocking our access to cleaner, cheaper fuels.*

Reality: This is a ludicrous claim. Oil companies have made big investments into solar, wind , and biofuels. In fact, the only company running a large scale cellulosic ethanol trial, Iogen, is receiving major funding from Shell.

Yes on 87 "Fact": *Prop 87 makes it illegal for oil companies to raise gas prices to pass the cost along to consumers.*

Reality: Prices are affected by supply and demand, not by propositions that declare it illegal to raise gas prices. Hawaii recently tried an experiment in price controls, despite warnings that consumers would be harmed. When the warnings came true, Hawaii abandoned this experiment.

Yes on 87 "Fact": *Requires strict accountability; nonpartisan, expert oversight and no new bureaucracy.*

Reality: Where I see no accountability at all is if this measure fails to achieve the desired results. In my opinion, it will raise gasoline prices for California consumers, while penalizing shareholders of oil companies. Where is the accountability to those groups for their lost dollars should this measure fail?

Yes on 87 "Fact": *California deserves its fair share and the oil companies can afford to pay it. But the opposition is lining up, contributing millions of dollars to spin, scare and deceive voters.*

Reality: Following this essay, you can decide whether California is getting a "fair share". You will also see that some Prop 87 proponents are guilty of spin and deception.

Truth in Advertising

I am confident that Prop 87 will raise gas prices in California. That's fine with me, because this should increase conservation. However, the Prop 87 proponents are promising Californians that there will be no increase in gas prices. Californians are being promised a free lunch; that in fact this new $4 billion tax will be borne entirely by oil companies.

I don't see it that way. Each year, oil companies decide where they will allocate capital based on expected returns for various projects. After the initiative passes, it will be less profitable to extract oil in California. The expected returns for some capital projects in California will decrease. California will get just a bit smaller capital allocation from corporate budgets, which over time will squeeze supplies. Not only will the returns from California be lower, but initiatives such as this are viewed as hostile toward the industry, providing another disincentive for investing capital in California. As investment slows and gasoline capacity fails to keep up with demand, higher prices will result.

Some proponents have declared this scenario unrealistic, because oil and gas prices are set on the global market. For example, in a recent report, ABC news reporter Mark Matthews asked the following question: "But will 87 raise the price of gas?" He then answered the question with "The price of oil is set on a world market, not state by state." What many people don't seem to understand is that there isn't a single price for oil. Oil prices vary greatly in different locations based on a number of factors, as Ana rightly pointed out in her previous essay. Prop 87 will improve the economics for importing oil into California, simply because it will increase the operating costs for California oil producers. So, even though West Texas Intermediate, for example, is set on the world market, the price for crudes produced in California will reflect California's specific circumstances. And those specific circumstances are set to change with passage of this proposition.

In fact, it seems that the only people who think gas prices won't be impacted are the Prop 87 proponents. According to California Politics Today:

> Proposition 87 may prohibit an "oil tax pass-through," but everyone but its sponsors agrees it will raise gas prices at the pump.
>
> Protecting consumers from price increases at the pump based on the levying of this tax is the implicit promise of Proposition 87's proponents and the form in which they are promising California voters the always-popular something for nothing, not to mention, as will be heard in the interviews below, promising to repeal the basic economic law of supply and demand, which, in this context, amounts to the same thing.
>
> Making "it illegal to pass the cost to us" is not the same as guaranteeing that passing Proposition 87 won't, on its own, cause gasoline prices to rise.
>
> As can be heard in the four interviews below with a range of experts and advocates in the fields of energy and economics, adding to the cost of oil produced in California cannot help but cause an increase in the price to consumers in California of gasoline.

So, in the interest of truth in advertising: Prop 87 will widen the gap between gas prices in California and the national average. Guaranteed. Not that there's anything wrong with that, since this will promote conservation.

Make Them Pay Their Fair Share. And Then Some.

Proponents of Prop 87 paint a picture in which oil companies operating in California are not paying their fair share for extracting California's resources. They will note that Texas has an extraction fee, and argue that California is getting a raw deal from the oil companies. However, to get an accurate comparison, we have to look at the entire taxation picture.

There are a number of ways that states receive revenue as a result of oil and gas transactions. Extraction taxes are but one example. Corporate income taxes are another example. So, even though Texas has an extraction tax of 4.6%, versus none for California, Texas does not charge oil companies a corporate income tax. California, on the other hand, charges oil companies an income tax rate of 8.84%, one of the highest in the nation. When times are good and oil companies are making big profits, states like California share in the "windfall."

According to the Long Beach Chamber of Commerce:

> Oil producers pay the state corporate income tax on profits earned in California. California's corporate income tax rate is among the highest of the top producing states. Texas, in fact, does not have a corporate income tax at all which provides producers a competitive advantage over California in trying to attract capital investment. California producers also pay a regulatory fee to the Department of Conservation (regulates oil

> production in the state) that is assessed on production, with the exception of production in federal offshore waters.

So, despite the claims that oil companies in California are not paying their fair share, they already pay a much greater percentage of their income to the state than they do in Texas. I bet oil companies would have no problem at all with the proposed extraction tax if California wants to waive the corporate income tax as Texas does.

Of course taxes on gasoline sales also provide a large revenue stream for state governments, but these taxes are paid directly by consumers. In California, not only does the state get $0.14 a gallon, they also assess a sales tax of 8.75%. When gasoline is $3 a gallon, this means that California receives $0.32 a gallon in combined sales and excise taxes. Here is the breakdown of gasoline taxes, according to the San Francisco Chronicle:

> If you're paying about $3 a gallon at the pump in Alameda County where the sales tax is 8.75 percent, here is an estimated breakdown of who gets what:
>
> -- Fuel price per gallon: $2.40
>
> -- Federal Excise Tax: $0.18
>
> -- State Excise Tax: $0.18
>
> -- Sales tax for state government: $0.14
>
> -- State bond debt payment: $0.01
>
> -- Sales tax for local government: $0.10

I can tell you without a doubt that the government take is significantly higher than the income that oil companies earn in California. In fact, according to the same article:

> Since 2002, sales tax revenues on gas have been growing annually by $300 million to $400 million to reach $2.86 billion in 2005, according to the California Board of Equalization.
>
> "There's a lot of blame to go around (when it comes to high fuel prices), but the government certainly should be on the list," said Bill Leonard, a member of the Board of Equalization. "The government is the biggest profiteer of them all."
>
> Higher prices at the pump are one reason the state will see a sizable revenue windfall this year. When Gov. Arnold Schwarzenegger updates his budget proposal Friday, he is expected to announce that the overall tax revenue is expected to be $5 billion more than his earlier estimate in January.

Isn't it interesting that the government is receiving the biggest windfall of all? It would seem that the logical place for the Prop 87 proponents to grab alternative energy funds would be some of this government windfall, given that this tax is already in place.

It also appears that the high state gasoline tax is the primary reason per capita usage of gasoline in California is low. After all, there is a very strong correlation between the states with the highest gasoline taxes - New York, Hawaii, California, Nevada, and Illinois - and the lowest per capita users of gasoline. While low per capita gas usage is certainly a good thing, it indicates that high state taxes result in lower product sales for oil companies in California than if California had Texas' $0.20/gallon gasoline tax rate. Again, I am sure oil companies wouldn't object much to Prop 87 if there was going to be a reduction to the sales tax rate, because they would sell more product. But the point is that the high gasoline tax is also affects the profits of oil companies in California.

The bottom line? Texas adopted one model: No corporate income tax, low gasoline taxes (leading to higher consumption), but an oil extraction tax. California adopted a different model: High corporate income tax, high gasoline taxes (leading to lower consumption), but no oil extraction tax. To suggest that oil companies are not paying their fair share in California simply because they don't pay an extraction tax is a grotesque mischaracterization of the actual tax situation.

A Transfer of Wealth

While the stated intent of Prop 87 is to make California less dependent on petroleum, let's be clear on exactly what it will do. Prop 87 is a transfer of wealth from one industry to a competing industry. In most cases, various subsidies are funded by taxes that we all pay in, and in fact many of the alternative technologies that Prop 87 would fund already receive very generous government subsidies. But on top of that, the proponents argue that it is appropriate to take from one special interest and give to another, because oil dependence is not good for us.

Let's put this in perspective. Fast food isn't good for us. Would most people consider it appropriate to place an additional tax on McDonalds and Burger King, and funnel the proceeds into health food stores? Would it be appropriate if I funded an initiative to achieve this, while at the same time investing in the health food stores that would benefit? Does anyone have a problem with that? Wouldn't it be more effective to assess a tax on the people who frequent McDonalds, if my goal is to reduce dependence on McDonalds? Why is it appropriate to assess an additional tax burden on one industry and funnel the money to a competitor? Why is it not more appropriate to funnel the windfall that government has received to fund alternative energy projects?

Most supporters of this transfer of wealth don't have a problem with it, but the money will mostly come from average working families and retirees who invested their money into company shares or into a mutual fund that owns company shares. These are the owners of Big Oil. It isn't primarily the Lee Raymond's that you are taking money from. The $4 billion comes from shareholders, and the "free lunch" comes at their expense.

And where is the accountability here? Let's say that Prop 87 does not have the desired effect of reducing petroleum consumption. Furthermore, let's say that it does indeed increase gasoline prices for California consumers, despite the assurances of the proponents. Ignoring for now the fact that Big Oil will of course be blamed for the increase in gas prices, how will Prop 87 proponents rectify this with the people of California? How will they rectify it with the shareholders from whom they extracted the $4 billion? The truth is, they won't be accountable for the failure of this measure. It will just be a $4 billion "oops", that is going to end up financially hurting a lot of people.

Lessons from Proposition 42

In 2002, California voters approved Proposition 42. According to this analysis of Proposition 42:

> Proposition 42 would permanently dedicate revenues from the state's share of the sales tax on gasoline to transportation projects. This sales tax on gasoline is already collected at the pump and generates roughly $1.3 billion a year.

Now that seems like a pretty good proposition to me. Take the sales tax that is being collected, and dedicate some of those funds to reducing the demand for petroleum (sort of like Prop 87, except you aren't taking money from the shareholders). 20% of the funds were supposed to be spent for mass transit and intercity rail. Fast forward to 2006:

Sales Tax on Gasoline a Bonanza for State

We find that the words "permanently" and "dedicated" are quite easily dispensed with:

> Revenue from state sales tax on gasoline is supposed to go for transportation projects under Proposition 42, which voters approved in 2002. But in recent years, legislators and the governor have invoked special provisions of the ballot measure that allowed them to dip into that fund, moving about $2.5 billion to pay for other expenses.

Hopefully, Prop 87 funds can't be similarly diverted. But it does make me wonder whether the legislature might be able to divert these funds into other areas.

Conclusion

I predict Prop 87 will pass, primarily because people see it as a way to stick it to Big Oil. I think the measure will decrease gasoline consumption in California, by making gasoline more expensive. Furthermore, I predict that the measure will be abandoned well before $4 billion is raised as the price disparity in California's gasoline market widens over the national average.

I actually favor higher gas prices, though. I think that will extend our supplies of oil. But I do have a problem with deceptive claims, especially when they are aimed at my industry. If I was in California, I am still not sure how I would vote. I think proponents missed an opportunity to write a much better proposition. I understand their need to write a politically palatable initiative, but I am turned off by hollow political promises. In conclusion, if you cast your vote for Prop 87, at least make sure you are voting based on facts, and not on spin.

Disclaimer: Once again, I want to make it clear that to my knowledge, my company is not fighting this measure, nor have they contributed any money toward doing so. I don't believe that we extract oil from California.. So, I have nothing to gain financially from supporting or opposing this measure. I am also not a resident of California, so my comments are those of an unaffected party.