Other views: What's wrong with regulating gasoline prices?

By Severin Borenstein -- Special to The Bee
Published 2:15 a.m. PDT Friday, September 12, 2003

BERKELEY - Gas prices are up, and politicians don't want to appear complacent. But in this case, they should leave things alone.

(***Editor's note:*** *Do to an editing error, the published version was incorrect. The first paragraph should have read:*

BERKELEY - Gas prices are up, and politicians don't want to appear complacent. But their response could be worse than doing nothing.)

Attorney General Bill Lockyer decries price gouging, while Lt. Gov. Cruz Bustamante advocates regulating gas prices and draws parallels to the electricity crisis. As someone who supported price controls in electricity, but opposes them in gasoline, I think it's important to understand the difference between these situations.

In any market, prices can fluctuate, even if sellers can't control them. California's house prices have skyrocketed, even though no one is withholding housing supply from the market or creating an artificial shortage.

Price increases that reflect real shortages send valuable signals to the market, rationing the limited supply that exists today and encouraging entrepreneurs to bring more of the product to market in the future.

But not all shortages are real, and not all high prices are caused by a simple principle of supply and demand. In some markets, a few sellers can make greater profits if they reduce their supply and drive up prices.

When that happens, the high prices are not reflecting a real shortage, and the signals they send to buyers and investors are misleading.

Whether the shortage is real or artificial, the sellers make money from the high prices and some customers are hurt in the short run. This invariably leads to calls for price regulation. The problem is that if the shortage is real, price regulation is more likely to harm consumers than to help them.

If there is a real shortage in the gasoline market, pushing prices down with regulation will cause demand to exceed supply, which means lines of people waiting to buy gas. In the gasoline market of the 1970s, and with many other price controls, the time spent in line and the inconvenience of some people not being able to buy the product at all outweighed the consumer savings from price controls. Also, if the shortage is real, price controls discourage investment in the market, leading to more shortages.

If, however, the shortage is created by sellers who are withholding supply, price controls can benefit consumers. A company's incentive to restrict supply diminishes if the company knows prices won't be allowed to rise beyond a certain point. In this case, price controls can decrease prices and increase supply.

So, the key is to know when high prices reflect real shortages and when they are artificially caused by sellers with market power.

With careful analysis, I and others studying the California electricity market concluded that prices were well above competitive levels, reflecting an artificial shortage created by sellers withholding supply. These studies of electricity production and prices have since been supported by internal documents of electricity producers.

No studies, however, have shown that California gasoline prices are significantly above competitive levels. Yes, prices are high, but there have been refinery disruptions as they've adopted a new formulation that includes federally mandated ethanol. Also, a pipeline break in Arizona caused some California gasoline to flow toward higher Arizona prices.

Do those real supply problems explain California's high prices? It is extremely difficult to know.

Remember the questions during the electricity crisis about whether a plant was legitimately down for maintenance or why it was producing less than capacity? Those questions are much more difficult to answer with gasoline because refining is a much more complex production process than electricity generation.

In addition, gasoline can be stored, so the price today also depends on how much gas is in storage, and how much will be produced and consumed in the near future. Regulators would be very hard-pressed to determine the competitive price of gas on any day.

California does have a real gasoline problem. Demand has outstripped the capacity to produce the state's low-polluting blend, causing real shortages. But the tight market also puts the largest sellers in the market - with market shares up to 24 percent - in a position to boost prices by withholding supplies.

Unfortunately, price controls are a dangerous response to this very real problem. Unless regulators can determine how much of the high price is due to real shortages, they are likely to make those shortages worse.

Instead, the state should push to increase supplies, either by permitting more refineries to be built in California or by helping smaller companies find out-of-state sources that can meet our strict pollution standards. More supply sources and more competitors are much more likely to benefit consumers than are price controls.

About the Writer

Severin Borenstein is director of the University of California Energy Institute, and a professor at UC Berkeley's Haas school of business. He can be reached at borenste@haas.berkeley.edu