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# Evidence doesn't back fuel scheme

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Don't regulate markets on scant research, argues **Henry Ergas**

ONLY three weeks ago, at a conference organised by The Australian and the Melbourne Institute, Finance and Deregulation Minister Lindsay Tanner was trumpeting the Rudd Government's commitment to letting markets work. Now the Government seems poised to regulate petrol retailing, despite findings by successive inquiries that the market is workably competitive.

Tinkering with markets that are functioning tolerably well is always dangerous, but especially so when interventions have effects that are difficult to model and may well prove harmful in the longer run. The West Australian FuelWatch scheme is a case in point.

FuelWatch has two key components: petrol retailers are forced to set their prices a day ahead, and those prices are made readily available to consumers. The intended effect arises from these components' interaction.

As consumers can learn where petrol will be cheapest, a greater share of sales is likely to shift to the retailers who post the lowest prices. Because the other retailers' prices are locked in, they cannot respond, and hence stand to lose more. The daily price-setting exercise becomes more of an all-or-nothing proposition. In economic terms, each retailer should face demand that is more elastic and respond to that by lowering margins.

Reality, however, is considerably more complex. Petrol retailing, even under FuelWatch, is not a simple, one-shot ``prisoner's dilemma'' in which identical retailers are forced to the lowest mark-up outcome by the fear of losing revenues.

Rather, retailers come in a range of sizes and structures and operate in a range of areas that differ in terms of the competition they face. Consumers differ, too, in their price sensitivity, their ability to travel to areas where there are many outlets, and even their preferences between brands.

In such a setting, a scheme such as FuelWatch can have significant unintended consequences.

To begin with, under FuelWatch producers do not face a once and for all price-setting exercise, in which all is at risk; instead, they interact repeatedly and can observe and respond to each other's behaviour. Over time, retailers are likely to learn how to play the system and use it to make prices higher and more sticky.

Additionally, the retailers who are most likely to gain are the larger, multi-site operators. They will benefit from a greater ability to analyse past outcomes and, hence, set prices better in the daily auction. The fact that they face each other in multiple markets will accentuate this effect.

At the same time, they can set prices so as to take advantage of owning many outlets, setting a low price in areas of greatest competition, while increasing prices at outlets that will be patronised only by the least informed, least price-responsive customers. These portfolio effects also make it less likely that a larger owner will face a string of days of low-margin sales that could seriously undermine the viability of a smaller, independent player. Combined, these factors are likely to change the industry structure towards fewer outlets and higher concentration, which seems plainly contrary to the intended effect.

The impact on consumers is also a mixed bag. Consumers who live in fringe or low to medium-density areas may well face higher prices as retailers come to terms with the fact that the mobile, best-informed buyers will shop elsewhere.

Even in central areas, the lowest daily prices are likely to fluctuate in a significantly smaller range, reducing the gain to those who previously bought when prices were at the bottom of the cycle.

Finally, greater concentration and fewer outlets are not likely to benefit consumers in the longer term.

It is an empirical question of how big these effects are. An econometric study commissioned by the Australian Competition and Consumer Commission suggests that FuelWatch has lowered prices. But there are many issues with that study, and even the statistical significance of its results is not clear, as it fails to adjust its measures of cost savings for the added time that consumers spend travelling to outlets and queuing for service. And the study does not explain how it is that petrol margins are higher, for the larger retailers, in Perth than in almost all the other capital cities.

It would be a big call to regulate one of Australia's most important markets largely on the basis of one far from conclusive econometric study.

It is hardly conceivable that a new pharmaceutical, which could have serious adverse side effects, would be approved on such a weak evidentiary basis. If the Government is really committed to evidence-based policy-making, it should think again.

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