The effect of non discrimination clauses on UK Retail Energy Prices

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Executive summary

The UK Government and energy regulator were among the forerunners in liberalising retail energy markets at the end of the twentieth century, and removed the last price caps in 2002. Competition had developed from a base of electricity monopoly in fourteen regions by each electricity company (who became the Big 5 through mergers and acquisitions) entering the thirteen regions where it was not monopolist. The national gas incumbent also entered each of the electricity regions. Competition generally developed by the entrants in each region undercutting the incumbent supplier to attract consumers to switch. Following political concern about the health of the energy market, the regulator instigated a review of the market in 2008 which revealed a persistently higher mark up by the Big 5 suppliers in areas where they had a history of incumbency, compared to those where they had entered, reflecting the fact that many consumers displayed considerable reluctance to switch supplier.

The regulator was concerned that vulnerable consumers might be adversely affected by this inertia, and introduced a number of remedies to reduce barriers to switching, and to the entry of suppliers from outside the 'Big 6' (the Big 5 and the national gas incumbent) historical incumbents in electricity and gas. The remedies included a non discrimination clause, which the regulator hoped would lead to a lowering of the margins charged in home areas. This paper examines whether there is evidence that predictions that this would be anticompetitive, and might lead to higher prices for all, were fulfilled.

The analysis is based on evidence of how the companies set their prices, relative to each other. The bill of a household using an average amount of electricity and paying by direct debit (the payment method used by most consumers, and particularly those who switch supplier) is used as the basis, and the analysis uses a Vector Autoregressive Model and Granger causality tests to identify how the companies responded to each other in setting their prices.

We find a change in the behaviour of the companies before and after the introduction of the non discrimination clauses which is consistent with the concerns that they might soften competition between the large players in the market. While they seemed to be putting

some constraint on each others' prices before the introduction of the clauses, this effect is absent or much weaker afterwards. The Big 5 seem to have 'retreated' to their home regions, leaving each regional market closer to a duopoly between the national gas incumbent and regional incumbent. Combined with the regulator's own figures on profitability, and a halving in the number of consumers switching energy suppliers between 2008 and 2013, this suggests that compliance with the clauses has resulted in higher rather than lower prices.

The regulator did not renew the non discrimination clauses after their initial three year period, but has since severely limited the number of tariffs which each supplier may offer, which will have some similar effects. Our analysis confirms that this particular regulatory intervention was not successful in lowering prices, and that the companies' response by increasing the complexity of special offers may have caused consumer confusion and reduced participation in the market. This itself has led to further regulatory intervention. The paper presents a cautionary tale both for this particular policy and for the dangers of well-meaning intervention by regulators or governments.