Retail price caps: sometimes the cure is worse than the disease

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Once upon a time in the UK, there was a problem in retail energy markets. The retail operators were maximising profit by charging 'loyal' customers higher prices than those who actively engaged with the market. In other words, the 'default' tariff ('standard variable tariff') was not, in practice, subject to sufficient competitive pressure. Many of these customers were old or vulnerable. The UK government (under some political pressure because a temporary retail price cap was a popular policy of the main opposition party) introduced a retail price cap via its energy regulator Ofgem, with the aim of protecting customers on the 'default' tariff. Unfortunately, they did not 'all live happily ever after'.

The wholesale price of some energy inputs, notably methane, has recently increased sharply. This has caused major issues in the UK's retail gas market. Although the price cap recently rose 12%, many suppliers are now leaving the market. The UK government and regulator have not been prepared to adapt the price cap regime rapidly; their stated defence is that those whose business model is not viable should not be rescued (which is fair enough) but it is also true that the cap protects consumers from sharp price rises and that raising the cap even further in April will be unpopular.

Consequently, many of the more aggressive entrant retail suppliers are facing negative margins for that part of their input wholesale gas costs that they have not previously hedged. More suppliers are likely to go out of business, and, in addition, even some of those that are (or claim to be) fully hedged have decided to leave the market. Their customers are being rehomed with other suppliers by the government. This system may in turn break down, because those better-hedged suppliers may not have access to sufficient gas at hedged prices to be able to supply these new customers; there will be net costs from this process. We expect that the bill for the clean-up will be mutualised (that is, even customers of resilient and responsible suppliers will pay).

A regulated price that is below the efficient costs of production is (simply put) not good regulation: it will lead to the required goods not being produced.

The retail price cap was created to try to deal with a different problem. Its designers did not think that it would face a situation where massive spikes in the wholesale input prices would revise the costs of supply so sharply during the price control period that the cap went below the (current) efficient cost of supply.[1] Patently, unless wholesale prices fall significantly, the cap will have to rise sharply when it is next reset. So, given that it will have to rise, consumers will only be protected against price rises for a limited period. In the meantime, significant numbers of the smaller and more dynamic operators have ceased trading, which has restructured the retail market. Looking to the future, it will hardly be surprising if the level of competitiveness falls if the market becomes more concentrated, and attractive tariffs other than the default tariff become difficult to create, making it difficult for small players to grow by out-competing existing ones. This in turn may make it more difficult to use competition as a mechanism to assist in minimising the costs of the vital transition to net zero, at least in the short run.

1 A past chief executive of Ofgem has said as much in a recent interview for the Financial Times.

Other solutions were available to address the original problem. For example, an explicit social tariff targeted at the poor and vulnerable would make that group less affected by any kind of loyalty penalty. Alternatively, an operator leaving the market has suggested that Ofgem could have used licence conditions to require that the suppliers' default tariff had to be their cheapest tariff; we note that this would have been a very bold move indeed, as it would have caused a very substantial change to the retail market.[2] While telecoms regulators have taken similar steps in the past, in relation to (for example) forcing retail calls to particular number ranges to be 'in-bundle' and the use of 'roam like at home' for international roaming in the EU, these decisions were easier for regulators (or parliaments) to take because (unlike the gas default tariff) neither of these steps related to a large fraction of the entire market.

What conclusions can we draw?

- Even if there are many other similarities with the utilities sector, we are fortunate that retail telecoms is not beholden to a wholesale market where prices fluctuate substantially.
- While it is often unattractive for regulators to explicitly consider market structure (for example, "how many suppliers do we need?"), not placing strong requirements on operators' business models and financial resilience risks a worse outcome with high costs arising from operator failures passed on to innocent suppliers and customers.
- Regulatory remedies need careful design; political pressure does not help in this process.

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2 A previous UK government did consider restricting the number of tariffs offered as a means of providing improved transparency.