A viable alternative to any damaging energy price cap

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Members of Parliament have warned that an “absolute” energy price cap will reduce competition and distort the market. But a “relative” cap is also likely to remove low-price offers. I propose an alternative approach that works with the grain of the competitive market.

What is the problem? Some cite the £1.7bn annual customer detriment calculated by the CMA. But this was not a conventional calculation: in aggregate, the “Big Six” energy companies have not made excessive retail profits. Some have made profits but two have made losses.

The £1.7bn assumed an imaginary world of super-efficient companies. Taking this approach, any sector might exhibit £1.7bn customer detriment. Demands for price controls would be endless. Hence an absolute cap is not required.

Are price differentials between customers a cause for concern? Surely not: at one time Ofgem cited such differentials as evidence that competition was working. Differentials are indeed found in many competitive markets, perhaps most. And in all competitive retail energy markets around the world.

Are the price differentials excessive? Unfortunately, the lowest price in the market is now regarded as “the competitive price” and higher prices are regarded as exploiting market power. But alleged market power has not yielded excessive profits, and the lowest prices are not viable competitive prices, for at least two reasons.

First, the low prices offered by about 50 small, new entrants are subsidised. Suppliers with under 250,000 customers are exempt from certain environmental and social costs imposed on larger suppliers. Second, the viability of present low prices is not yet established. Only last week, new entrant Brighter World Energy dropped out “because we no longer believe that market conditions, or our underlying operation, make for a sustainable business model”.

Most suppliers cannot survive by charging a uniform price. At a high price they lose customers and can’t replace them. At a low price they don’t cover total costs. So they need the ability to attract new customers at lower prices than they charge existing customers. A relative price cap would jeopardise the competitive market. There is documented evidence. In 2008, Ofgem’s non-discrimination clause removed suppliers’ ability to charge differential prices.

Suppliers responded by eliminating their lower prices, customer switching and competition were reduced, and industry profits rose.

Although the present retail market is competitive, there is none the less a public concern that could be addressed. Many people think the Big Six suppliers have had it too easy. They have not had to fight to attract loyal customers, by demonstrating consistently lower prices or better customer service.

New entrants have had a more challenging task. They can acquire price-sensitive customers quickly by pricing low, but building up a reputation to attract loyal customers takes time. Thus, for historical reasons, the Big Six suppliers are not under as much competitive pressure as the entrants. At privatisation, the retail part of the market was not restructured. Can we now speed up the competitive process by doing so?

I suggest we can, by adopting an approach that proved successful in generation. To avoid investigation and possible further measures, the "Big Two" generators (National Power and PowerGen) accepted a regulatory invitation to sell 10pc of their total capacity to new entrants. This had to be existing mid-merit plant, where competition was least effective, rather than base load plant that entrants themselves were building. After the disposals, competition increased.

A fully competitive generation market was soon established, which the CMA has verified. So, suppose the Big Six suppliers were each invited to transfer to a subsidiary company 10pc of their total existing customer base, then sell this subsidiary to one or more new entrants. The customers should have been with the company for at least three years, preferably since the market opened. Customers could have an opt-out provision if desired. This would not be appropriation without compensation: entrants would purchase the subsidiaries at market prices, just as supply businesses have always been bought and sold.

Ofgem would need to be satisfied that customers' interests would be protected.

With the Big Six suppliers presently having about 40m customer accounts, this would mean about 4m customers becoming available to new entrant suppliers. Given the different sizes of the Big Six suppliers, the subsidiaries might range from roughly 0.5m to 1.5m customers. But smaller or regional groupings would be quite possible if that were more manageable.

As with generation, further customer sell-offs could be considered as a quid pro quo for allowing mergers. And some large suppliers might find slimming down attractive.

Any price cap would restrict competition, but this approach would stimulate competition. It would give new entrants better opportunities to prove the merits of their prices and customer service. It would encourage the Big Six to become more efficient and customer-sensitive. It would help to transform this market. It would thereby address a public concern in a constructive rather than potentially destructive way.

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