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Why price caps don't **work for customers**

The Government has promised to introduce a price cap on UK household energy bills and the regulator is taking steps to implement that policy. They argue that it will mean lower prices. But we believe that the cap won't work and will have harmful consequences for customers.

We're not alone. The Government's own competition watchdog thinks that a retail energy price cap will be bad for customers. The Competition & Markets Authority says that a cap on all default tariffs would "run excessive risks of undermining the competitive process, likely resulting in worse outcomes for customers in the long run".

What are energy price caps, and what are they for?

A price cap is a type of restriction on the amount that energy retailers can charge customers for their energy. There are different sorts of retail price caps:

- They can apply to all customers; or to a subset of customers.
- They can be absolute (e.g. no more than £X per unit of energy consumed); or relative (e.g. no more than X% difference between tariff A and tariff B).
- They can be set in advance by regulators (known as "ex ante"); or set by suppliers and monitored by regulators ("ex post").
- They can apply to all constituent parts of the bill (total price); or just one part of it (e.g. a limit on profit margins).

There are different sorts of retail price caps because they have different objectives. The most common reason for having retail price control is to manage the transition from a nationalised industry to a fully competitive market, known as liberalisation. As liberalisation progresses, more customers engage in the market and more suppliers enter. As competition keeps prices down, price caps are withdrawn. It is very unusual for price caps to be reintroduced to competitive markets after they have been withdrawn.

Why price caps don't work in competitive markets

Retail energy price caps are very difficult to set, because they need to strike a balance between competing objectives. In practice, no regulator has ever got the balance perfectly right because it is an impossible task. Customers want prices that are as low as possible. But companies need to be able to recover their costs, to invest and to make a fair margin.

Setting price caps at a low level seems attractive. But companies can't recover their costs when the cap is set too low. Recent history is littered with examples of the disastrous consequences. Here are just two:

- In 2001 in California, retail prices were capped at levels that ended up being below the wholesale cost of energy. As a result, the main energy retailers found themselves US$20 billion in debt and one of them went bankrupt. They could not buy electricity on the wholesale market, so the state (i.e. the taxpayer) had to step in.
- In Spain, the "tariff deficit" (the difference between retail price caps and actual costs) reached €29 billion or 3% of GDP. The deficit sits as an unconditional liability on the Spanish Government's balance sheet (i.e. it is guaranteed by taxpayers).

Competition is squeezed out when the cap is set too low, which means that customers lose out:

- Prices bunch around the cap. This happened with tuition fees in the UK, with the majority of universities charging maximum rates.
- It has also happened with the pre-payment meter (PPM) price cap. On average, prices are now within £15 of each other and they have bunched around the cap, with quite a few of them going up, not down. Suppliers appear to be following the energy buying strategy that the PPM cap assumes, so their wholesale energy costs will be similar. PPM customer switching is also slowing relative to other customer groups.
- Customers have little incentive to engage in the market and search for the best deal, because there isn't much money to be saved from switching. In France's more regulated market, electricity switching recently reached a peak equivalent to 8% on an annualised basis in 2017. In the UK switching is nearly 17%.
- Suppliers can't afford to invest or innovate to attract customers, because they won't be able to make reasonable returns on their investment.
- Customer service quality suffers, as suppliers seek to make savings. Indeed, some companies may try to avoid supplying certain groups of customers altogether, as some currently do with customers on pre-payment meters.
- The market isn't attractive for potential new entrants, and can lead some existing players to leave the market.

Price caps that are set too low can also have damaging implications for Government policies, for example, suppliers might not have enough money to invest in infrastructure, such as smart meters and energy efficiency measures.

Price caps are not always disastrous, but they are not a model to follow. In Belgium, for example, where the price cap appears to have become permanent, retail energy prices are higher than in the UK and there are fewer suppliers.

But in markets where competition is allowed to flourish freely, without a price cap, the benefits to customers in terms of choice and affordability are clear. In Texas, for example, there are now 116 energy suppliers and 34% of customers switched suppliers in 2016.

We do not support price caps on retail energy prices as a way of reducing bills and we believe they are counterproductive. Where caps are introduced it is vital that they are limited in scope and duration. Setting a cap at a level where suppliers cannot recover their costs would be disastrous.