



The Case Against the Energy Price Cap

By Dillon Smith

Executive Summary

- Although introduced with the best intentions, the Energy Price Cap (EPC) has gone far beyond its intended purpose and is actively harming competition, leading to higher prices for consumers and higher inflation
- The EPC was originally brought in as a time-limited intervention to protect a specific group of customers from price-gouging
- For a time it worked as intended – but the recent energy crisis has meant it now functions not as a price cap, but as the de facto price for almost every consumer in the market
- Ofgem has also, in the wake of recent upheaval, introduced policies which actively disincentivise firms from trying to attract new customers
- The result is that competition in the energy markets has basically been frozen, resulting in significantly higher prices for consumers and contributing to inflation
- Ultimately the cap was designed for yesterday's market and is not fit for purpose in the current era of higher and more volatile wholesale prices
- The Government must chart a strategy for a return to competitive energy markets, which should include removing the EPC in its current form while strengthening protections for those who genuinely need support

1. The history and purpose of the Energy Price Cap

The Energy Price Cap has always been a product of politics as much as policy – and all the more so today.

In pure policy terms, the genesis of the price cap lies in a two-year [investigation](#) of energy markets by the Competition and Markets Authority (CMA), published in 2016. The investigation was driven by a combination of high energy prices (or at least what seemed like high energy prices at the time) and questions around the business practices of the energy firms, particularly the 'Big Six' suppliers.

The CMA found that many customers were experiencing a 'loyalty penalty', whereby once a discounted 'acquisition tariff' expired, those who chose not to switch would be rolled onto a Standard Variable Tariff (SVT), which was often poor value for money. Such a large 'back book' of disengaged customers gave the 'Big Six' significant market power, which they exploited fully. The CMA estimated that due to the prevalence of this strategy, the average gains from switching for some categories of customer (whether suppliers, tariffs and/or payment method) were equivalent to more than 20% of their bills – to their mind 'particularly striking since electricity and gas are entirely homogenous products.'



The CMA thus recommended a series of remedies designed to make the energy markets more competitive through stronger customer engagement (i.e., persuading people to pay more attention to their energy bills) and regulatory changes.

However, they acknowledged that these changes would take time to implement and bed in, and thus recommended a 'transitional price cap' from 2017-2020 – but crucially, only for those on prepayment meters. Such customers were seen as particularly vulnerable to price exploitation given competition constraints in this smaller corner of the market, and the fact that such customers would have to cut back on consumption substantially if prices rose too high.

The CMA did in fact consider extending this proposal to all customers on SVTs – but decided the risks outweighed the rewards. As their report explained, 'The majority of us believe that attempting to control outcomes for the substantial majority of customers would – even during a transitional period – run excessive risks of undermining the competitive process, likely resulting in worse outcomes for customers in the long run. This risk might occur through a combination of reducing the incentives of suppliers to compete, reducing the incentives of customers to engage and an increase in regulatory risk.'

The CMA also saw clearly that the heart of the issue was essentially customer laziness – or, for some elderly customers, incapacity. As they put it, 'We also note that for most domestic customers on standard variable tariffs detriment will be reduced as soon as they engage effectively, in contrast to the situation for prepayment customers, who do not have access to cheap tariffs.'

This was a vision of the EPC, in other words, that saw it as a way to correct a particular problem with an otherwise competitive market, focused on one set of particularly vulnerable customers. At the same time, however, Ed Miliband as Labour leader was setting out [a more grandiose vision](#) of an energy strategy that would freeze prices when they got too high, as well as forcing energy firms to pass on cuts in wholesale costs as prices fell.

So, inevitably, once the cap for prepayment customers was in place, politics took its course. The 2017 [Conservative manifesto](#) promised to 'go further' and 'extend the price protection currently in place for some vulnerable customers to more customers on the poorest value tariffs.' This was never intended to be a permanent solution – as then business secretary Greg Clark laid out in a [letter](#) to the 'Big Six', 'We have said previously that our intention is to introduce a temporary cap to protect consumers, while the objective of a more competitive market is achieved.'

The [legislation](#) therefore included a sunset in 2020 with a possible extension (on an annual basis) until 2023, subject to achieving 'effective competition' in the market. Alongside the cap the Government committed to a [package](#) of measures including faster switching and

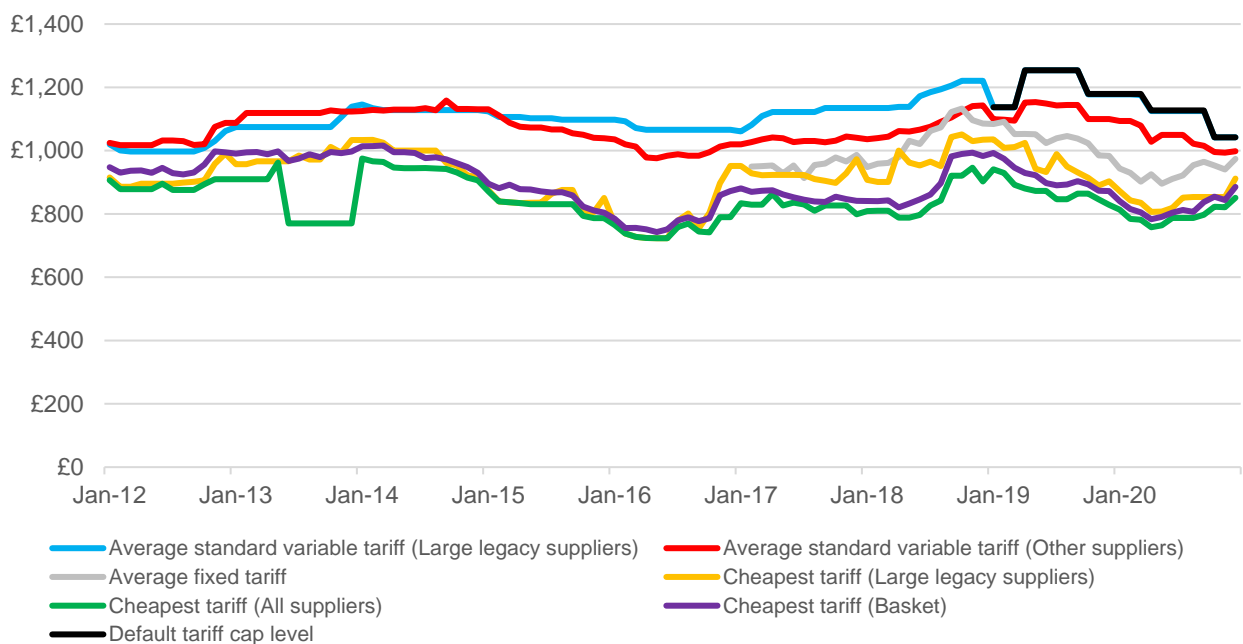


continued smart meter rollout. Yet as with so many other theoretically temporary policies, it started to become a permanent feature of the system.

This new version of the price cap, which came into force in January 2019, was much closer to Miliband’s vision – a cap on what suppliers could reasonably be expected to charge their customers, both for unit rates and standing charges. (Ofgem includes a [variety of factors](#) in calculating this, the largest being wholesale energy costs but also network costs, ‘green levies’, VAT, a rate of return and so on). The analogy that is often used is to minimum wage legislation, where the regulator sets a ‘fair’ level and then lets competition thrive above this. Although in this case of course, the pricing structure is the other way around.

And before the energy price crisis this is how it worked, as the graph below shows (we will get to the more recent version later). The EPC, while far from perfect, genuinely functioned as a cap, with relatively healthy competition below this level across a variety of tariffs and suppliers. In particular, given that the EPC applied only to variable tariffs, suppliers continued to offer cheaper deals below these levels, and thus switching remained healthy, not least due to the rise of ‘auto-switching’ or collective bargaining services such as The Big Deal, Look After My Bills and Switchd.

Comparison of retail prices by tariff (2012-2020)



Note: All prices in the chart are calculated using Ofgem’s ‘typical domestic consumption values’, which change slightly over time (and will be updated again in October). All figures are based on a typical domestic dual fuel customer paying by direct debit. This data excludes acquisition-only tariffs or other tariffs with limited availability based on customer features. Ofgem calculates the cheapest tariff basket based on a simple average of the ten cheapest tariffs available in the market (one per supplier).

Source: [Ofgem](#) (Chart: Retail price comparison by company and tariff type: Domestic (GB))



2. The energy crisis and the transformation of the Energy Price Cap

It was in 2021 and 2022 that everything changed. A substantial rise in wholesale prices was hugely exacerbated by Putin's invasion of Ukraine. This had the effect of pushing a large number of suppliers into insolvency, most famously Bulb – not least because, during the preceding period, the market had been flooded by multiple, thinly capitalised new entrants which lured customers with fixed-rate deals that became horrendously unaffordable as prices rose.

As a result, Ofgem commissioned Oxera to review its regulatory regime and the operation of the energy market. While the [Oxera review](#) primarily focused on Ofgem's lax oversight of those suppliers with riskier business models, it also noted the exacerbating influence of the EPC, namely the gap between volatile wholesale prices and the six-month review period. Ofgem subsequently [announced](#) last summer that the price cap would be updated on a quarterly basis, though it also [has the power](#) to change the cap mid-period in 'exceptional circumstances'.

Given the volatility of wholesale prices, suppliers understandably began withdrawing cheaper fixed-price tariffs from the market – a few remained, but they were far more expensive than the capped price. So as customers rolled off these deals, or were thrown off them by the collapse of their suppliers, the number of people on standard variable tariffs increased hugely. In [August 2021](#) the cap protected roughly 15 million domestic customers – [a year later](#) that number was 24 million. As of [April 2023](#) (the latest numbers available) the EPC covers a staggering c. 29 million households – against only 3 million or so still on fixed tariffs.

In other words, a policy that was originally brought in to 'protect' disengaged or vulnerable customers now rules almost the entire market. The EPC has now become the de facto market price. This has obviously removed any incentive to change supplier – particularly once the Energy Price Guarantee superseded the EPC last winter. Switching rates have predictably [fallen off a cliff](#), from 496,000 per month in 2019 to just 85,000 per month in 2022.

As if this wasn't enough, Ofgem has recently made liberal use of a little-known but very powerful instrument called the Market Stabilisation Charge (MSC). This activates if wholesale prices move more than 10% from the price cap level, which has been the case almost continuously [since November](#).

Under this system, any time a customer switches, then the winning supplier has to reimburse the losing supplier, at a rate set weekly by Ofgem.

The justification for this is that because retail prices are capped under the EPC over a three-month period, suppliers are heavily exposed to wholesale price volatility, and thus are forced



to hedge themselves to mitigate this risk – all the more so given the increasing number of customers on price-capped tariffs.

That hedging, however, carries a risk that if prices fall, other suppliers who did not hedge as heavily could introduce cheaper tariffs, poaching away customers and thus leading to heavy financial losses at the original supplier, and in extreme cases insolvency.

Put another way, Ofgem is so worried about suppliers failing that it is actively discouraging the introduction of tariffs that would cause significant switching. This of course has a destructive effect on competition, as the regulator itself admits. In its recent [decision](#) to extend the policy, it noted: 'We acknowledge that the MSC in its current form is likely to have some impact on market competition. At a time of such price volatility, this needs to be balanced against the much reduced risk of expensive, disorderly or unplanned exits from the market in the absence of any stabilising measures which can result in consumer detriment through increased bills.'

Given the furore surrounding supplier failures, one can understand how such a policy came into being. And indeed the MSC goes hand in hand with the price cap – Ofgem itself [describes them](#) as 'inextricably linked'.

Yet these two policies have collectively had a devastating effect on competition in the retail market. Over the last two years, as the below graph shows, almost all tariffs have been priced right at or just below the price-capped level. While the latest data does not cover July (when the Energy Price Guarantee expired and was superseded by the EPC), there is little evidence that this pattern is being broken. A few fixed price deals [have trickled out](#), but primarily for existing rather than new customers – and generally priced within 1% of the EPC level. (Obviously, volatile wholesale prices in and of themselves will make suppliers wary of offering fixed deals – but the EPC and MSC only exacerbate this tendency.)

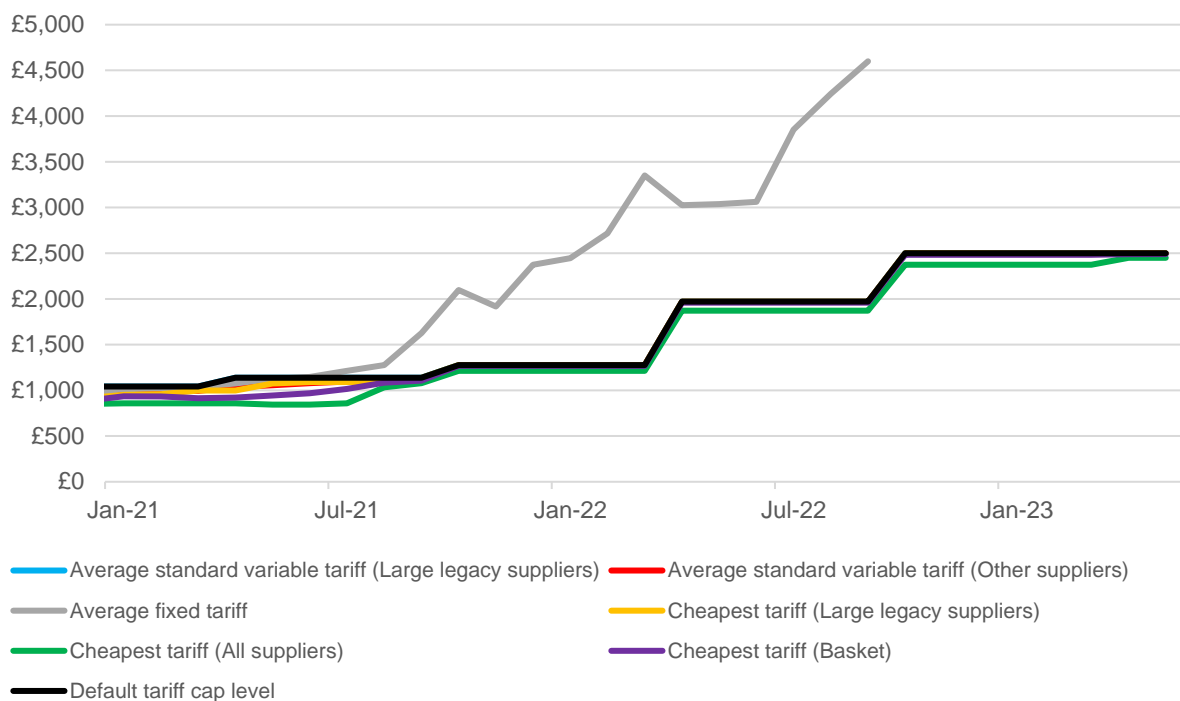
The EPC has now well and truly become something it was never intended to be. It has gone from being a temporary policy aimed at protecting a particular segment of customers to a system in which the Government sets the market price which almost everyone pays, with little end in sight. And a policy originally intended and justified as a bridge to stronger competition has ended up contributing to its destruction.

This system does at least smooth out the impact of spikes in wholesale prices, and ensure transparency in passing on the savings from a falling market through to customer bills. But in so doing it has led to a retail market in which there is no possibility of competition driving down prices, or of anyone getting a better deal. The knock-on effect of high prices for consumers shows up in measured inflation, which as of [June](#) is running at 7.3% – slightly better than earlier this year, but still eye-wateringly high.



Even the much-praised transparency of the price cap is not quite the virtue one might have assumed. Ofgem has had to constantly tinker with the formula in order to nursemaid suppliers through wholesale volatility. Yet this has sometimes led to bizarre situations – witness the predictable outrage that followed Centrica’s half-yearly [results](#), which showed a nearly 900% increase in operating profits, in large part due to backward-looking ‘cost recovery’ allowances Ofgem introduced. While these may be justified (given that, for example, suppliers had to purchase energy at above-cap prices for customers rolling onto SVTs), it led to the bizarre spectacle of Ofgem having to [publicly defend](#) the profits of the suppliers it regulates (pleading that they are ‘one-off’). Put simply the price cap was conceived of in an era of relatively benign wholesale prices – and is patently no longer fit for purpose in today’s market.

Comparison of retail prices by tariff (2021-2023)



Note: All prices in the chart are calculated using Ofgem’s ‘typical domestic consumption values’, which change slightly over time (and will be updated again in October). All figures are based on a typical domestic dual fuel customer paying by direct debit. This data excludes acquisition-only tariffs or other tariffs with limited availability based on customer features. Ofgem calculates the cheapest tariff basket based on a simple average of the ten cheapest tariffs available in the market (one per supplier). Default tariff cap level reflects the EPG for the period it superseded the EPC. Data to May 2023.

Source: [Ofgem](#) (Chart: Retail price comparison by company and tariff type: Domestic (GB))



3. The new normal

As policymakers look to the future, it is important to recognise that wholesale market dynamics may not return to the status quo ante. Indeed, the International Energy Agency has [warned](#) that price volatility could easily return if we get a cold winter and Russia cuts its remaining gas supplies. Meanwhile, Cornwall Insight has [predicted](#) that wholesale electricity prices will not fall to their pre-crisis levels until the late 2030s. The energy transition and geopolitical uncertainty could well mean that high and volatile prices will stay with us throughout the decade.

It is not clear this thinking has pervaded government – for example while [Ofgem](#) ‘acknowledge[s] that the MSC is not intended to be a long-term intervention’, it states that its ‘intention is to remove or replace the MSC when market conditions reach a level of sufficient stability’, or if it finds another way to manage these risks.

The potential for sustained wholesale market volatility is a recipe for yet another ‘temporary’ intervention to become quasi-permanent. Indeed, some would say that the Energy Price Cap has proved its worth during the crisis, and it would be unthinkable to get rid of it now.

We would, however, flip that argument on its head. We would argue that the spike in wholesale prices, and the political and cost of living implications, shows that government will always come under pressure to act in cases of emergency, price cap or no price cap. It has also shown that one-size-fits-all measures such as the EPG can be extraordinarily, horrifyingly expensive.

Energy prices are unlikely to return to their pre-crisis levels anytime soon. Without reform, the great danger facing us is that the public becomes used to the Government directly setting the price of energy (whether via the EPG or EPC), thus freezing a wartime system in aspic – resulting in less competition and higher prices for years to come.

4. Towards a better system

In its [Powering Up Britain](#) strategy, the Government promised to consult this summer on the future of the price cap and ‘a new approach to consumer protection in the energy markets from April 2024 onwards’. While it is likely too late to make any changes for this winter, ideally such changes should be in place ahead of the 2024-25 period.

In looking to design a new system, the Government should keep five key principles in mind. The first is a return to a retail market that has competition and low prices for consumers at its heart. That means abolishing the EPC in its current form, and ensuring that the Government no longer dictates the price of energy as it does today – in the end, the best protection for consumers is competition.



There will always be customers who need protection, not least given how fundamental affordable energy is to our way of life. But the EPC was never designed to protect everyone, and nor should we aim to.

As Martin Lewis of Money Saving Expert [told](#) the BEIS Select Committee in March last year (just after the Russian invasion): 'I would prefer to see, in normal times – and I do stress that – us defining who are legitimate victims of the market. If I or you choose not to switch, hard luck. You should know better. If a struggling 90-year-old grandmother who has dementia chooses not to switch, she needs much greater protection than the price cap currently affords...'

We agree. We therefore suggest that alongside reform of the current price cap model, the Government should introduce stronger protections as a bulwark against fuel poverty – our second principle. Indeed Lewis and [many others](#) have argued for a 'social tariff', which would support households spending an excessive proportion of their income on energy bills (going further than current programmes such as the Warm Home Discount). This would better target state funding to those who need it, going beyond those in receipt of benefits to include those on lower incomes in energy inefficient homes. There will clearly be all sorts of details to resolve around precise eligibility, setup, how this new system should be funded and so on. But the coming consultation is the time to set out a longer-term system built for the current era of higher bills. As with the original vision for the EPC, there should also be protection for those on prepayment meters, given their vulnerability to exploitation and lower levels of competition in that market.

Moving beyond vulnerable customers to the broader market and those on SVTs, the third principle is a new approach to tackling the 'loyalty penalty' which more effectively balances competition and protection. Indeed abolishing the price cap cannot mean returning to the 'bad old days' of the two-tiered market.

Making the ban on acquisition-only tariffs permanent (so that all tariffs must be offered to existing customers as well as new ones) could help tackle this issue in a less interventionist manner, although at the expense of competitive pressures on suppliers. Another approach (not mutually exclusive) is a 'relative cap', whereby any supplier's SVT could be priced no more than [X]% higher than their cheapest tariff. While setting the cap level would of course be contentious, this could help deliver a more effective proxy of competition for those who are currently disengaged from the market.

In a similar vein, initiatives focused on lowering barriers to switching would be sensible, such as the Government's previously paused [work](#) on an 'opt-in' switching scheme. So too would the continued rollout of smart meters, which should help with customer engagement, particularly as the take-up of EVs and heat pumps continues.



Whatever mechanisms are chosen, both for the wider market and vulnerable customers, the Government must ensure they are resilient and built for the long-term – our fourth principle. As discussed above, we may well be entering an era of higher and more volatile energy prices – and even if prices do eventually return to ‘normal’ levels, this cannot be the basis for policymaking. Instead the future regulatory regime must be resilient and designed for ‘today’s market’, ensuring that in a pinch the public are not left wondering what support they will receive while the Government struggles to find the cash.

The fifth key principle is that any future system needs to encourage innovation and support our net zero ambitions. For example, dynamic time-of-use tariffs (where the price of electricity varies with each half hourly period) create incentives to shift consumption away from peak times and reduce costs for consumers, while bolstering our decarbonisation efforts. Yet such innovative tariffs and other flexible solutions are impossible to reconcile with the current price cap, both from a practical perspective and in terms of incentive to invest. The Government thus needs to ensure any new system is future-ready, with maximum openness to new technology options and innovative products for consumers. The Government’s recent [call for evidence](#) on this topic is a step in the right direction, but these considerations must flow in to the larger discussion on overall retail market design. From a delivery perspective, getting the smart meter rollout and Market-Wide Half Hourly Settlement over the line as quickly as possible are critical pre-requisites for the flexible system we desire.

Above all, the Government must ensure that competition returns to our retail markets in place of state price controls – which as every economic textbook (and indeed every lesson from history) will show, is also the best way to protect consumers in the long term.

Dillon Smith is the CPS’s lead researcher on energy and environment policy