"There is a route out of this energy nightmare …"

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The retail energy sector is a nightmare. The average annual domestic bill will rise from about £1,000 until recently to over £4,200 next year. Many customers can't afford this. Long-term policy options include increasing energy supplies, renewables, storage, energy efficiency and home insulation. But what about now?

Prompt but selective action is necessary. We don't need to be panicked into suspending the Tariff Cap Act, freezing energy prices, or renationalising loss-making suppliers. Nor is the solution to continue the price cap beyond 2023. It was set below cost, and nearly 30 suppliers went bust, while others left the market because supply profits are negligible or negative. The cap has not prevented significantly higher prices and cannot legally do so. It has limited the variety of suppliers, increased hedging costs and risks, and thereby increased retail prices.

The price cap has destroyed one of the most competitive retail energy markets in the world. There is no longer a market price, only a loss-making regulated variable tariff at which suppliers don't want customers, plus a few much higher fixed tariffs that customers don't want to buy. Switching has essentially ceased. And to protect suppliers from the risks of the cap, Ofgem has introduced customer stabilisation charges … to reduce competition. What sensible business would invest in this sector, and innovate, to help solve the coming environmental challenges?

The CMA advised against a price cap. The dissenting CMA panel member said that "the short duration of the cap (two years or so) reduces the risk that it will become unworkable as a result of unforeseen events". But the cap was left to run beyond two years and became unworkable. Ofgem should phase it out by the end of 2023, per the Act.

Is the solution a relative price cap, to prevent suppliers offering lower prices to new customers (the so-called "loyalty tax")? No. Ofgem previously introduced a non-discrimination condition to prevent a "regional loyalty tax". The CMA found that it reduced competition and increased prices. Ofgem removed it.

A few suppliers have voluntarily adopted a uniform tariff or similar-tariff policy but have never attracted more than about 15 per cent of all customers. The main proponent, Bulb Energy, went bust and some other suppliers abandoned the policy. A relative price cap would be a "dog in the manger" policy, preventing a price cut to some customers if all can't have one. It would be a costly and needless restriction on competition that would not address today's problem.

Is a social tariff the answer? If that means a uniform tariff specified by Ofgem which all suppliers have to offer to certain specified types of customers, then no. It would involve all the problems of the present price cap. And Ofgem would be constantly pressed on the differences between regulated and unregulated tariffs. In contrast, if a social tariff means encouraging suppliers voluntarily to provide lower tariffs or other benefits to their most vulnerable customers, that is desirable. Suppliers produced various valuable social tariffs in 2008-2010. But there were arguments about comparisons: did deferring price increases count? And government was not satisfied with the level of benefits offered. A voluntary approach would not cope with today's problem.

The outcome of those earlier explorations was the Warm Home Discount (WHD) scheme, which provided a specified price reduction to a specified set of pensioners and low-income customers, as determined by government. It is financed by a levy (under £20) on all customers, hence by higher income customers.

The WHD details need further consideration, including to expand the customers eligible. But importantly, it works. Suppliers and customer groups accept it, and it has all-party support. It does not distort the market because it does not prescribe what tariffs suppliers offer, nor restrict any customer's choice of tariff. Paid as a lump sum, it provides financial support without suppressing the energy prices that realistically must incentivise customers to reduce usage where possible.

The WHD scheme could form the basis of a social tariff – more precisely a social discount scheme – to address today's major challenge. It can harness the three main sources of funds for reducing the energy bills of the poorest and most vulnerable customers.

The first source is relatively affluent customers who already provide support. They could afford a little more, via an increased WHD. The second source is taxpayers, who have already made a significant contribution, but more is needed. This could be channelled via a modified WHD – for example, allowing more frequent payment, or higher payments to the most needy. The third source is businesses who have unexpectedly profited from the increase in wholesale energy prices. In May, the Government introduced a temporary windfall tax on UK oil and gas profits and there is talk of including electricity generators.

Since a windfall tax is controversial, note that major energy companies have previously been encouraged (rather than compelled) to put customers above their own immediate interests, and have responded. During the 1990s the major generators were encouraged to sell plant to new entrants to increase competition. In 1995, when National Grid was privatised, the Regional Electricity Companies as interim shareholders were encouraged to give a significant rebate to customers.

Government needs to decide several urgent but manageable details. A social discount scheme based on enhanced WHD would protect vulnerable customers while a thriving competitive market was restored, thereby facilitating the innovation and incentives necessary to transition to a low carbon economy.

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