

# The cost of loyalty

Exploring how long-standing customers pay more for essential services



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## **Citizens Advice: exploring the loyalty penalty in essential markets**

This report is part of a programme of work examining how essential markets, including energy, telecoms and financial services, exploit consumer loyalty. Providers frequently tempt new customers in with cheaper deals and then raise prices over time, taking advantage of the fact that consumers have busy lives and won't get round to switching. As a result, loyal customers often end up on uncompetitive deals, paying far more for a service than a new customer would.

Our series of briefings on the loyalty penalty is a call to action for government and regulators. The loyalty penalty is not only unfair because it affects vulnerable people the most. This report also suggests that competitive pressures do not apply to significant sections of essential markets - making them inefficient and unproductive.

# Contents

<b>Summary</b>	<b>3</b>
<b>Background</b>	<b>6</b>
<b>Research method</b>	<b>9</b>
<b>1: What is the loyalty penalty?</b>	<b>10</b>
<b>2: Why do people experience the loyalty penalty?</b>	<b>15</b>
a. Choosing the best deal	15
b. Choosing to stick with a deal	21
c. Choosing to exit a contract	27
<b>3. What does the loyalty penalty mean for the wider economy?</b>	<b>33</b>
<b>4. Conclusion</b>	<b>36</b>
<b>Appendix</b>	<b>44</b>

# Summary

Loyalty is often seen as something to be encouraged, even rewarded. When a customer is loyal to a supermarket or coffee shop, for example, they often receive discounts or special offers from the business in return.

But when it comes to essential service markets - such as energy, mobile, broadband and financial services - things are different. Instead of being rewarded, long-standing customers often pay more. While this cost has been acknowledged in the energy market, it has not been widely recognised in other markets such as broadband. This research shows how people face a 'loyalty penalty' across essential markets and could be overpaying by as much as £987 - more than 4 months' worth of food for the average household. And it's often vulnerable consumers who pay the most.

The loyalty penalty is not only unfair, it is bad for the economy too. Markets which are well-functioning are powered by choice. People proactively choose the products and services they buy. And fierce competition by companies for those choices drives down prices and fuels innovation and efficiency. This research finds that essential service providers undermine consumer choice, using processes which take advantage of people's behavioural biases. This suggests that, even in ostensibly competitive markets, firms may lack strong enough incentives to develop innovative new products and improve customer service. Both consumers and the wider economy lose out.

Choice is hindered at three key stages of the consumer journey, leaving many on poor value deals:

- **Choosing a good deal: finding the best value contract is often difficult and many people don't spot the loyalty penalty.** Two in five (39%) consumers are unaware of the loyalty penalty in essential markets and over a third (35%) say it's too hard to shop around. Providers hide the loyalty penalty deep in terms and conditions where few people will find it.
- **Choosing to stick with the same deal: prompts to inform people when their fixed deal is expiring are often ineffective.** Three quarters (75%) of broadband customers are not aware of ever being informed by their provider that they could save money by moving to a cheaper deal. And in the mortgage market, providers rely on post to communicate with customers rather than allowing people to choose their preferred method of communication.

- **Choosing to exit a contract: barriers deter people from switching.** A quarter (25%) of people think it's difficult to exit an essential service contract. And many who choose to stay mistakenly think they are on the best deal available.

Regulators and government should seize opportunities to address the loyalty penalty. They should adopt measures that promote choice, increase competition, and protect vulnerable consumers across essential markets:

- **Regulators should introduce targets for providers to reduce the loyalty penalty.** They should monitor how many people are affected, how badly they are affected, and set targets to reduce the penalty's impact.
- **The Competition and Markets Authority (CMA) should investigate possible solutions to the loyalty penalty for vulnerable consumers.** Ofgem is consulting about whether to extend its price cap for vulnerable consumers. The CMA, in taking forward its work on vulnerable consumers, should look at the loyalty penalty and the case for tackling it systematically across essential markets
- **Regulators and the Advertising Standards Authority (ASA) should improve framing of information across markets.** For example, in the mortgage market, the 'standard variable rate' label should be changed to the 'expired rate' to better describe the nature of the contract.
- **Providers should be required to send much more effective, timely nudges.** The Financial Conduct Authority (FCA) has recently introduced new rules in the insurance market and other regulators should follow suit. Consumers should also be able to choose how their provider alerts them when their initial deal ends.
- **Providers and regulators should remove barriers to exiting a contract, making switching more straightforward and hassle-free.** For instance, suppliers should commit to ensuring the same method used to enter a contract is available to customers who want to exit.
- **Regulators should encourage the use of data and digital tools which help consumers to get a better deal.** New technology can play a big role in addressing the loyalty penalty. Government and regulators should focus on how new tools can be supported to scale up and meet the needs of vulnerable consumers.

The public's faith that markets can deliver has been shaken. The government has opportunities in its Industrial Strategy and Consumer Green Paper to set out a positive vision for how they can work better for everyone. This report outlines the size of that challenge. The aim should not be to eliminate the loyalty penalty - competitive pressures can drive good outcomes - but the dial needs to shift

back in the favour of consumers. The Green Paper should reaffirm that markets should be judged by what they achieve for consumers, not by theoretical notions of what a market should or shouldn't look like.

The government has shown a willingness to act. Just as they have committed to intervening in the energy market, they should be willing to take practical action in other markets where too many consumers are getting a bad deal and those least able to pay are often charged more.

# Background

When it comes to people's living standards, spending is as important as income. Britain's consumers spend £1.3 trillion on goods and services each year.<sup>1</sup> When consumer markets work well, this spending is a powerful force for good. But the importance of consumers markets for our lives also means that, when they fail, that failure carries a heavy price, resulting in rip-off deals, scams and shoddy services. And often, it's the vulnerable who are hit hardest of all. With Brexit on the horizon and prices already rising, it is crucial that spending leads to good outcomes for consumers in the coming years.<sup>2</sup>

Rooted in data from the 778,000 consumer problems we help solve every year, Citizens Advice has unparalleled insights into consumer detriment. Our previous research has shown that consumer problems ruin lives and cost us £23 billion a year.<sup>3</sup> One common problem we see is people paying high prices for essential services when they are loyal to a provider. Traditional economic theory holds that consumers, as 'rational' actors, will shop around so they are on the best deal. But in essential markets this often doesn't happen. Across energy, telecoms and financial services, large numbers of long-standing customers are on poor value deals.

Behavioural insights help explain why. One of the strongest forces in consumer behaviour is inertia, also known as the status quo bias.<sup>4</sup> This describes people's tendency to stick with a previous decision. As a result, the way choices are designed can have a big impact on consumer behaviour, even when the economic incentives for a consumer are clear. Providers of essential services exploit this to charge steep prices to long-standing customers.

In recent years, there has been a focus on improving the 'choice architecture' for consumers by making it easier and simpler for them to switch. For example, in the retail banking sector, the Current Account Switching Service (CASS) was launched to reduce frictions switching for Personal Current Accounts, Charities and Business Current Accounts.<sup>5</sup> Encouraging consumers to consider their options and simplifying the switching process can help people to access better deals and also drives competition in the market. But there is growing evidence of the limitations of interventions focused on driving switching.

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<sup>1</sup> Sum of past four quarters of [ONS consumer trends data](#). Quarterly household final consumption expenditure total (£ billion), seasonally adjusted, Q4 2016 to Q3 2017.

<sup>2</sup> ONS, [UK consumer price inflation](#), December 2017.

<sup>3</sup> Citizens Advice, '[Consumer detriment: Counting the cost of consumer problems](#)', September 2016

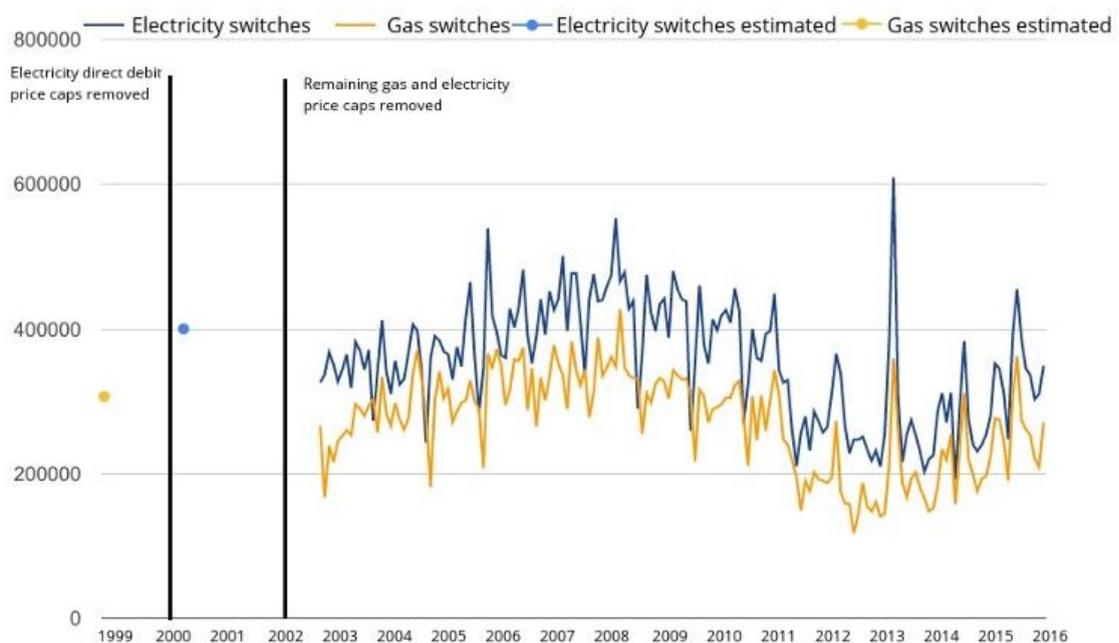
<sup>4</sup> Samuelson, W. and Zeckhauser, S., 'Status quo in decision making', 1988.

<sup>5</sup> Behavioural Insights Team for Citizens Advice, '[Applying behavioural insights to regulated markets](#)', May 2016.

Despite the introduction of simpler choices in the energy market, levels of consumer engagement have not increased substantially. As the chart below shows, switching rates were actually higher when energy price caps were in place around the turn of the century compared with switching rates over the past six years. This suggests that ‘rational’ economic incentives are not always driving consumer behaviour.

### Chart 1: Switching rates were higher when energy price caps were in place in the early 2000s compared with switching rates over the past 6 years

Number of electricity and gas switches, monthly, 1999-2016



Source: Department for Business, Energy & Industrial Strategy, *Transfer statistics in the domestic gas and electricity markets in Great Britain. Pre-2003 estimates from National Audit Office*

Recent regulation has focused on the time it takes to switch from one supplier to another. But the length of time it takes to decide whether and where to switch is likely to be at least as important as how long the switch itself takes.<sup>6</sup> The focus assumes that shopping around more is always a positive thing. In fact, our recent research shows consumers actually feel less satisfied when they spend a ‘good’ amount of time reaching a decision.<sup>7</sup>

<sup>6</sup> The Behavioural Insights Team, [Behavioural Insights Team response to Energy market investigation: Notice of possible remedies](#), 2015.

<sup>7</sup> Citizens Advice, [‘Against the clock’](#), November 2016.

To date, there has been far less scrutiny of provider behaviour. This presents an opportunity for policymakers to broaden their approach to tackling the loyalty penalty.

# Research method

This report uses a variety of different research methods to gain insight into how the loyalty penalty affects people across essential markets. These are summarised below with further details set out in the Appendix.

Citizens Advice researchers audited behaviour across major providers in each market using desk-based research, including contacting providers by live web-chat and telephone. These providers were identified by size and market share. Further details can be found in the Appendix.

This was supplemented with insights from two nationally representative online surveys run in January and June 2017. Populus ran two surveys of 3,196 and 3,070 people respectively in the energy, telecoms and financial services markets. Data were weighted to be representative of the UK population. Data about the respondent's gender, age, household income, level of education, mental health, region, housing tenure and ethnic group were also recorded. Populus is a founder member of the British Polling Council and abides by its rules.

The report also includes insights from the Citizens Advice Network Panel. This is a monthly survey sent to over 800 staff and volunteers across England and Wales, asking about their experiences of and views on policy issues.

When calculating the size of the loyalty penalty and the groups likely to pay it, we tailored our methodology to the specific market in question. Full details of our approach can be found in the Appendix to this report.

Qualitative evidence can be found throughout this report. This comes from an open text question in our January 2017 survey, from our Network Panel survey and from adviser casenotes. Where unattributed, quotations come from members of the public who responded to our survey. All case studies come from evidence forms completed by local Citizens Advice offices, and have been anonymised to maintain client confidentiality.

Finally, we would also like to thank the Behavioral Insights Team for the advice and suggestions they provided for this report.

# 1. What is the loyalty penalty?

The loyalty penalty is the cost of being a long-standing customer, compared to a new customer receiving the same product or service. In markets such as energy, broadband and home insurance, this occurs when loyal customers default onto a more expensive 'standard' tariff once their original contract comes to an end. In markets such as savings accounts and fixed-rate mortgages, it means providers moving people onto poorer value interest rates instead. In the mobile handset market, the loyalty penalty involves providers continuing to charge people the same amount even after they have paid off the full cost of the handset.<sup>8</sup> Whilst the design of the loyalty penalty varies from market to market, its impact is the same - loyal customers pay more for the same service than new customers. Table 1 below shows the cost of experiencing the loyalty penalty for one year in all 6 markets focused on for this report.

**Table 1: The cost of paying the loyalty penalty for one year in six markets**

<b>Market</b>	<b>Penalty</b>
Energy	£110 <sup>9</sup>
Mobile (including handset)	£264 <sup>10</sup>
Broadband	£113 <sup>11</sup>
Home insurance	£13 <sup>12</sup>
Fixed rate mortgage	£439 <sup>13</sup>
Savings account	£48 <sup>14</sup>
<b>Total penalty</b>	<b>£987</b>

<sup>8</sup> While SIM-only contracts make up a substantial proportion of the market, contracts including both mobile service and the cost of the handset make up around two-thirds of the post-pay mobile service market. Ofcom, [Pricing trends for communication services in the UK](#), March 2017.

<sup>9</sup> This is the average difference between each supplier's standard variable tariff and the cheapest deal for a medium dual fuel user paying by direct debit, weighted to reflect the number customers the supplier has on the standard variable tariff. The suppliers included are those that Ofgem publishes data on number of SVT accounts for. The rest of this report is based on analysis of the 'big six' energy suppliers.

<sup>10</sup> Citizens Advice, [Mobile phone networks overcharging loyal customers by up to £38 a month](#), 2017.

<sup>11</sup> Citizens Advice, [Exploring the loyalty penalty in the broadband market](#), 2017.

<sup>12</sup> This is the amount overpaid on a combined policy renewed after 1 year. In a nationally representative survey of UK households, 57% of respondents had a combined policy. This figure was calculated using data from the FCA and the AA British Insurance Premium Index. Further details in the Appendix.

<sup>13</sup> Citizens Advice, [Exploring the loyalty penalty in the mortgage market](#), 2017.

<sup>14</sup> This refers to the loyalty penalty for cash ISAs. Given the range of different savings accounts available, this report focuses on cash ISAs because they are a type of savings account that many people have and about which there is robust data. See Appendix for an explanation of how this figure was calculated.

The numbers of people who face the loyalty penalty in different essential service markets are large. 12 million UK households are on standard variable tariff accounts in the energy market.<sup>15</sup> In the home insurance market, 12.9 million households auto-renew after 1 year, meaning they pay more expensive premiums.<sup>16</sup> Around 1.2 million mortgage holders on standard variable rates would be better off switching to a cheaper deal.<sup>17</sup> As the table above shows, those who face the loyalty penalty in all 6 markets focused on in this research could be paying as much as £987 per year for being a long-standing customer in essential service markets. This is equivalent to over 4 months' worth of food for the average household.<sup>18</sup>

**Figure 1: Many people are paying the loyalty penalty in essential service markets**



## Vulnerable customers are more likely to face the loyalty penalty

“Loyal customers are seen as cash cows. Anybody that is not on the internet, is elderly, sick or poor gets charged a lot more than new customers and on pay as you go customers pay even more.”

“Older people particularly with no knowledge of the internet and comparison sites are more likely to stick with the same providers and just accept the charges.”

<sup>15</sup> Ofgem, [Dermot Nolan Speech at the Future of Energy Supply conference](#), September 2017.

<sup>16</sup> According to the FCA report [Occasional Paper No. 22](#), September 2016, insurance premiums rise by an average of 8% when renewed after 1 year. More details can be found in the Appendix.

<sup>17</sup> Citizens Advice, [Exploring the loyalty penalty in the mortgage market](#), 2017.

<sup>18</sup> ONS, [Family Spending in the UK: financial year ending March 2016](#), released February 2017.

Often those least able to pay the loyalty penalty are the most likely to experience it. This is because vulnerable groups are more likely to stay in their contracts for longer. Traditional economic theory assumes that people will exercise choice in markets and this in turn drives competition. But as this research shows, some groups of people struggle to exercise choice, especially in complex markets.

Compared to 18-64 year olds, people who are 65 and over are more likely to pay a higher price for the same service in all of the markets focused on in this report. Findings from psychology may help to explain why. We know that cognitive functioning declines with age,<sup>19</sup> and that having too many options to select from can leave people less happy not more.<sup>20</sup> Evidence also shows that older people are less likely to make optimal decisions when faced with many options,<sup>21</sup> and are more likely to defer choices when faced with complexity.<sup>22</sup> It may be that those aged 65 and over are more likely to face the loyalty penalty because they are less able to choose the best deal and more likely to stick with the status quo in complex essential service markets.

## Figure 2: Older people are more likely to pay the loyalty penalty

Compared to 18-64 year olds, people aged 65 and over are:



<sup>19</sup> Zelinski E.M. and Burnight KP., '[Sixteen-year longitudinal and time lag changes in memory and cognition in older adults](#)', Psychology and Ageing, 1997.

<sup>20</sup> Schwartz, B, '[The Tyranny of Choice](#)'. Scientific American, 1 December 2004.

<sup>21</sup> Besedes, T. et al., '[Age Effects and Heuristics in Decision Making](#)', Review of Economics and Statistics, 2012.

<sup>22</sup> Chen, Y. et al., '[Age Differences in Trade-off Decisions: older adults prefer choice deferral](#)', Psychology and Ageing, 2011.



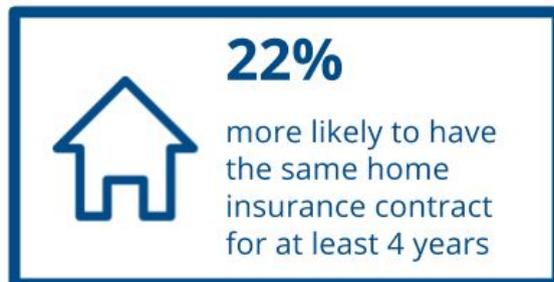
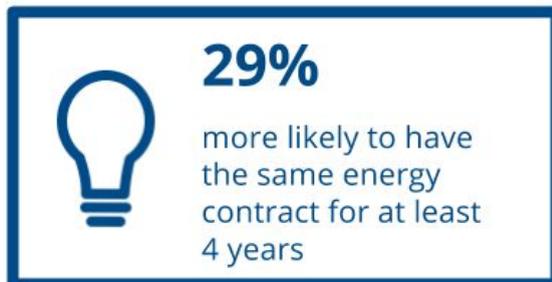
Beth, a 71 year old pensioner without computer access, came to Citizens Advice for help when her energy contract was coming to an end. Beth was keen to stay with her provider, who had supplied her energy for 10 years. However, her new tariff would cost £100 more each year than her previous deal, which she couldn't afford to pay.

After searching for a quote on the provider's website, Beth's adviser found an energy tariff £200 cheaper than the amount her provider had quoted - and £100 cheaper than her current deal.

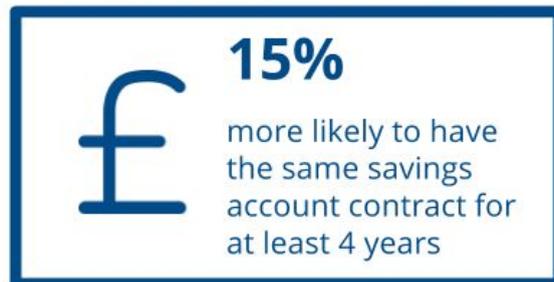
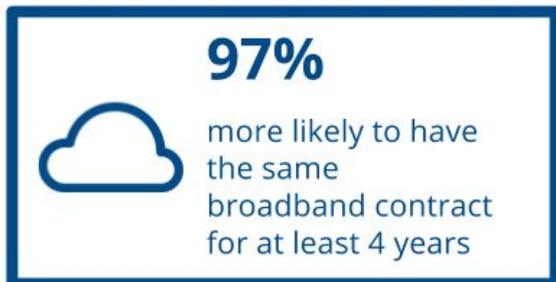
People on lower incomes<sup>23</sup> are also more likely to pay the loyalty penalty in a range of essential service markets. Those on low incomes may be failing to switch due to the effects of the 'scarcity mindset': the tendency for those who are worried about their financial situation to have less cognitive capacity to devote to other areas of their life.<sup>24</sup> The scarcity mindset may also explain why social renters are 32% more likely to face the loyalty penalty in the energy market compared to owner occupiers, and 77% more likely compared to private renters.

### Figure 3: People in low incomes are more likely to pay the loyalty penalty

Compared to the average, people on lower incomes are:



Compared to those on the highest incomes, people on lower incomes are:



Finally, across a range of essential markets, people without a university degree are more likely to face the loyalty penalty. Evidence suggests that adults with

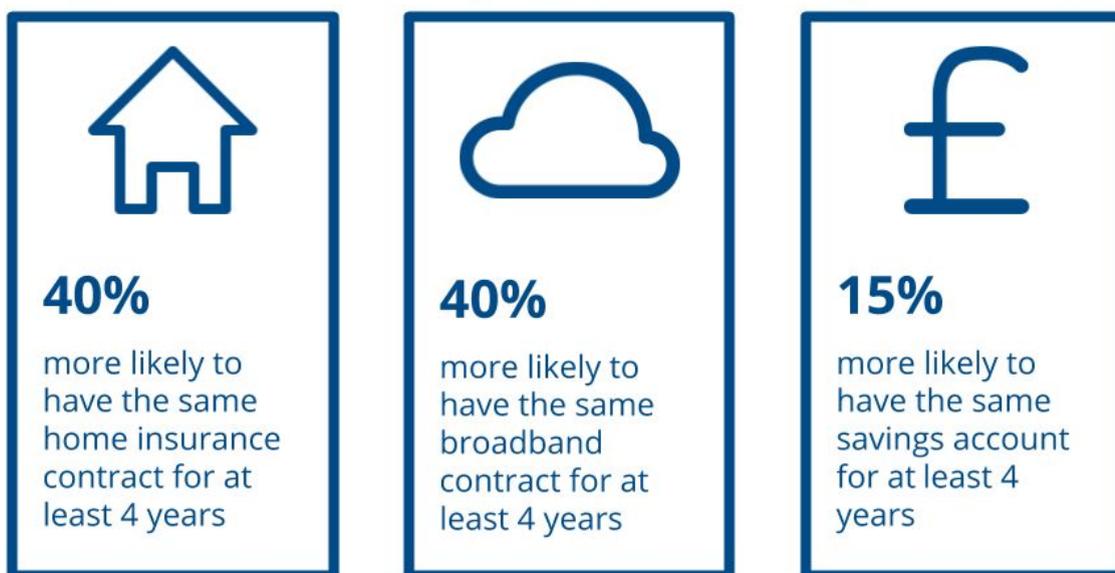
<sup>23</sup> People on lower incomes are defined as those with a combined annual household income of up to £7,000. The highest income bracket is £83,001 or more.

<sup>24</sup> Mullainathan, S. Shafir, Scarcity: The true cost of not having enough. 2014.

degrees tend to perform better in complex tasks compared to those who are less well educated.<sup>25</sup> It may be that people who did not go to university are less active in essential service markets because they have lower levels of confidence dealing with complex processes and products.

#### Figure 4: People who didn't go to university are more likely to pay the loyalty penalty

Compared to those with a degree, people who didn't go to university are:



The groups this research identifies as being more likely to face the loyalty penalty mirror those the Competition and Markets Authority (CMA) investigation into the energy market found to be less likely to have switched energy supplier between 2011 and 2014.<sup>26</sup>

There are policies which recognise that greater protections are necessary for vulnerable consumers. For example, water companies' social tariffs reduce bills for those on low incomes, and Ofgem's cap on energy bills for those on prepayment meters addresses the lack of effective competition in the prepay market, whose users are primarily low income. Likewise, Ofcom's cap for landline-only customers cuts costs for a group of people who are often elderly or on low incomes.<sup>27</sup> The fact that the same vulnerable consumers are less likely to switch and drive competition across a range of essential services - and are more likely to pay more for the same service as a result - suggests that greater protections may be necessary.

<sup>25</sup> Tun, P. and Lachman, M., '[Age Differences in Reaction Time and Attention](#)', *Developmental Psychology*, 2008.

<sup>26</sup> CMA, [Energy market investigation: Final report](#), 2016.

<sup>27</sup> Ofcom, '[BT's landline-only customers set for cheaper bills](#)', February 2017.

## 2. Why do people experience the loyalty penalty?

The loyalty penalty is the cost of being a long-standing customer, compared to a new customer receiving the same product or service. But why do people face it? This research examines people's experiences at each stage of the consumer journey, and finds essential service providers exploit people's behavioral biases in ways that hinder choice. The specific behavioural biases effective at each stage are highlighted at the beginning of each section below.

### a. Choosing the best deal

"Even as an adviser with 7 years experience, [it can be] very difficult to work out which deal is best"

Citizens Advice Adviser

#### Key behavioural biases at this stage of the consumer journey

##### Choice overload<sup>28</sup>

When presented with a large number of options, consumers can become 'paralysed' and are likely to either opt for the default, delay a decision or choose badly.<sup>29</sup> Studies also show that creating additional or more complex choices leads to higher prices.<sup>30</sup>

##### Anchoring

When people make decisions along a numerical scale, seemingly trivial or irrelevant information can 'anchor' them and shift behaviour.<sup>31</sup> For example, increasing the minimum payment displayed on credit card statements raises the average payment amount.

<sup>28</sup> Lyengar, S. S., & Lepper, M. R. When choice is demotivating, *Journal of Personality and Social Psychology*, 2000.

<sup>29</sup> Tversky, A., & Shafir, E. Choice under conflict, *Psychological science*, 1992; Gourville, J. T., & Soman, D. Overchoice and Assortment Type, *Marketing Science*, 2005; Wilson, C., et al. [Irrationality in consumers' switching decisions](#), 2005.

<sup>30</sup> Carlin, B. I. Strategic price complexity in retail financial markets. *Journal of Financial Economics*, 2009; Kalayci, K. [Price Complexity and Buyer Confusion in Markets](#), 2011; Kalayci, K., & Potters, J. Buyer confusion and market prices. *International Journal of Industrial Organization*, 2011.

<sup>31</sup> Tversky, A., & Kahneman, D. Judgment under Uncertainty, *Science*, 1974.

### **Framing effects**

Preferences shift depending on how choices are framed.<sup>32</sup> When consumers search for deals, the framing of costs or terms and conditions can be crucial. Presenting a mobile handset contract as '£50 a month with £250 upfront' makes it seem less attractive than '£50 a month with a half price handset'.

### **Present bias**

People tend to focus on the benefits of present consumption and discount future costs.<sup>33</sup> A US trial found that people were 13% more likely to choose a credit card offer with a low introductory interest rate that would be more expensive overall, compared to offers with no introductory deal.<sup>34</sup>

Competitive markets rely on consumers exercising choice. This drives down prices and fuels innovation. However, this research finds that providers across essential markets make it difficult for people to make informed choices when selecting a deal. A third (35%) of respondents think it is not straightforward to find a good deal in essential service markets.

This chapter highlights how many people do not realise loyalty is penalised in these markets, before considering two key reasons why.

## **People often don't realise there is a penalty**

It can be difficult for people to understand that loyalty is rewarded in some markets, but penalised in others. More than 9 in 10 (96%) respondents to this research think providers of essential services should charge loyal customers the same or less than new customers - and 39% think they already do.

"A service is a service. A product is a product. I wouldn't expect to pay any more or any less for the same loaf of bread from a supermarket based on how often I bought the same item from the same place."

People's awareness of the loyalty penalty varies between markets. As Chart 2 shows, people are less likely to expect it in financial services, like bank accounts and mortgages, than in markets like energy.

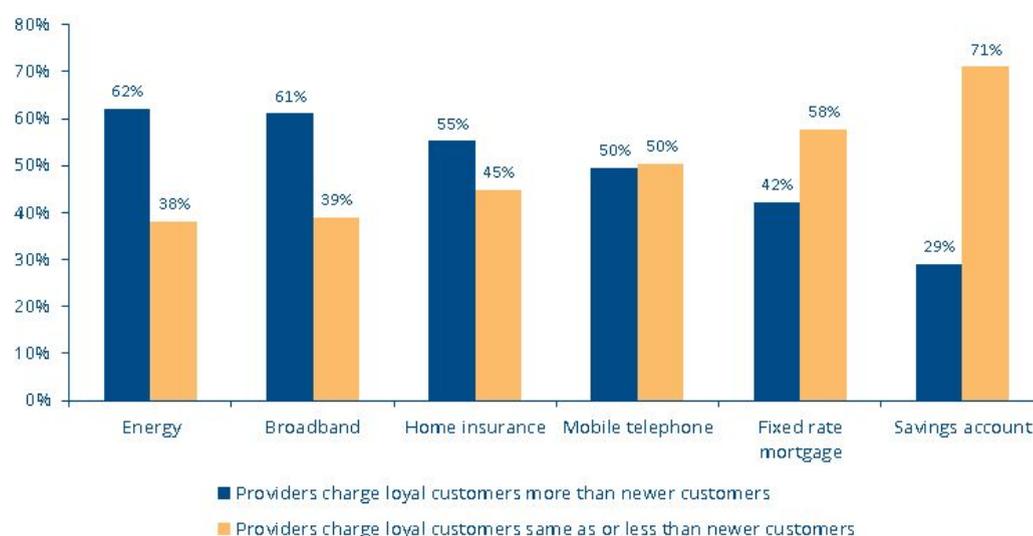
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<sup>32</sup> Tversky, & Kahneman. The framing of decisions and the psychology of choice. Science, 1981.

<sup>33</sup> Barber, B. M. et al., *Out of Sight, Out of Mind*, Journal of Business, 2006; Liebman, J. B. *Schmeduling*, Harvard University and NBER, 2004; Laibson, D., Golden Eggs and Hyperbolic Discounting. The Quarterly Journal of Economics, 1997; Samuelson, W., & Zeckhauser, R. Status quo bias in decision making. Journal of Risk and Uncertainty, 1988; Thaler, R. H. 'Some Empirical Evidence on Dynamic Inconsistency'. Quasi Rational Economics, 2001.

<sup>34</sup> Shui, H., & Ausubel, L. M. *Time inconsistency in the credit card market*. 14th Annual Utah Winter Finance, 2004.

**Chart 2: People are less likely to expect the loyalty penalty in financial services**



Source: Citizens Advice analysis of Populus data<sup>35</sup>

This may be because the penalty presents itself slightly differently in financial services. Consumers are less likely to view interest rate changes as a ‘cost’ similar to higher prices, and the long-term nature of products like mortgages means some people will be protected from interest rate ‘shocks’. It could also be because the energy loyalty penalty has been widely publicised in recent years, while similar practices elsewhere have received comparatively little attention.

Across essential markets, some common trends and behavioural biases help explain why people struggle to anticipate the loyalty penalty.

## Complex pricing structures undermine choice

“There is an awful lot of confusing competition out there - people just want an easy to manage and understandable set up without always having to shop around for better deals.”

To make the right choice about a product or service, people need clear and appropriate information about the cost of the service they are signing up for. An audit of essential service providers’ advertising practices shows how many fail to provide this.<sup>36</sup> Combined with natural behavioural biases, these advertising practices make it difficult for people to access information about the loyalty penalty before making a choice.

<sup>35</sup> Question: ‘For the following services, do you think long-standing customers are likely to pay more or less than newer customers?’ Bases vary by market and exclude those who answered ‘Don’t know’.

<sup>36</sup> For each market, we examined the behaviour of those providers with the largest proportion of market share, since their practices impact the largest number of consumers. More detail can be found in the Appendix to this report.

## Key information is often patchy or hidden

Across essential markets, people are rarely provided with clear, upfront information about the loyalty penalty. In some cases, such as in the broadband and mortgage markets, it is at least possible to discover the price after the initial deal expires. But often this can only be found deep in terms and conditions.

What's more, spotting the loyalty penalty often requires a good understanding of the market. For instance, while broadband providers include specific details about the default tariff, mortgage providers typically only list the future interest rate - meaning people have to calculate the price impact themselves. This is significant, since people have 'widespread misunderstanding and unrealistic expectations about how much variable rates could change'.<sup>37</sup>

The labelling used in some markets could be actively impeding consumer understanding. Four of the six main energy providers give no indication that their standard variable tariff (SVT) is likely to be the most expensive option. Indeed, the description of tariffs and interest rates as 'standard' in the energy and mortgage markets may imply to consumers that these deals are the 'normal' options. And while 3 of the 7 main mobile handset contract providers display the cost of the handset upfront, 3 providers offer no accessible information to help consumers break down the total price. Not only does this make it difficult for consumers to compare deals, it also makes it hard to understand what is the cost of the mobile service, and what is the cost of the technology.

In the home insurance market, it is difficult to find any price information without searching for a specific quote. It is also difficult to understand what is driving future price changes. Research shows premiums are likely to increase, regardless of claims made or changes in circumstance.<sup>38</sup>



Ellen, a 72 year old widow, came to Citizens Advice after receiving an unexpectedly high energy bill. When she had taken out her energy contract, Ellen believed her provider was supplying the electricity at their best rate. However, after receiving an unexpectedly high bill, Ellen realised she was actually on the provider's 'cheapest standard tariff' - in practice, the most expensive tariff offered by that provider. Ellen was very upset by this, since she believed the provider had placed her on their cheapest deal.

<sup>37</sup> FCA, [Cash Savings Market Study](#), 2015.

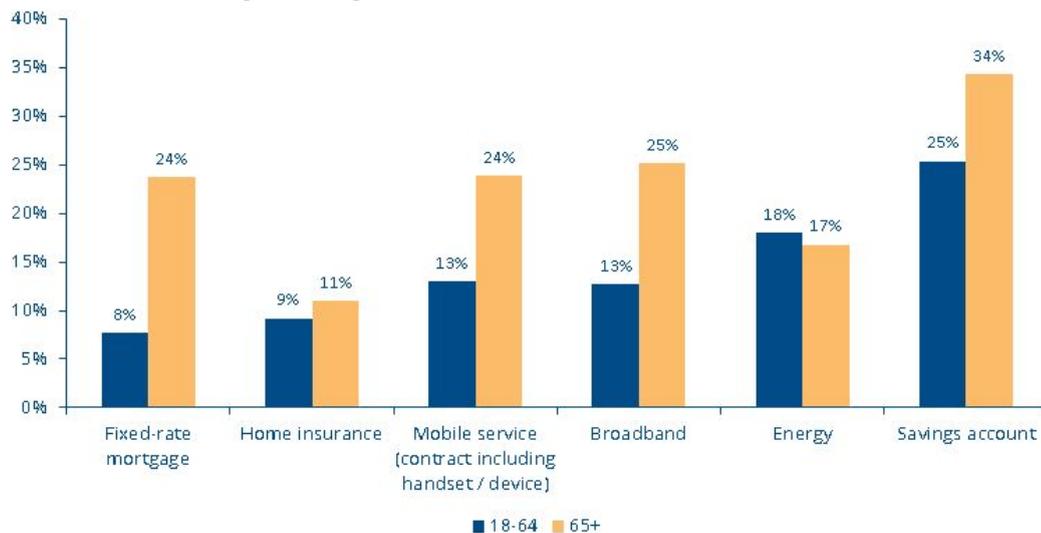
<sup>38</sup> FCA, [Price Discrimination and Cross-subsidy in Financial Services](#), 2016.

## As a result, many struggle to choose the best deal

All this means that even when people try to shop around, they can end up feeling overloaded by complex and confusing information. Previous Citizens Advice research found that consumers are less inclined to shop around in complex essential service markets.<sup>39</sup> In the face of such complexity, people either resort to inaccurate ‘rules of thumb’, or they stick with the default option.

Vulnerable people are particularly likely to find this process difficult - and as a result, many disengage. This research finds that 41% of those who currently have a mental health problem think it’s not straightforward to find a good deal in essential service markets, compared to 31% of those who have never experienced a mental health problem. And as Chart 3 shows, people who are 65 or over are more likely to have done no shopping around before entering a contract than those aged 18-64.

**Figure 3: Older people are more likely to have done no shopping around before entering a range of essential market contracts**



Source: Citizens Advice analysis of Populus data<sup>40</sup>

This trend is also present among those with lower education levels. Those without a university degree are more likely to have done no shopping around before entering an essential service contract than those with a degree.

<sup>39</sup> Citizens Advice, *Against the Clock*, 2016.

<sup>40</sup> Question: ‘Before entering your current contract for any of the following essential services, how much shopping around did you do, if any, to examine the various options in the market?’ Bases vary by market.

## Shopping around is time-consuming and difficult

Consumers shopping around to assess the different deals offered by providers will always be central to a well-functioning market. But people also lead complex, busy lives, often juggling work and caring commitments. This research finds that 39% of consumers would like to spend more time shopping around. This falls to 27% among those aged 65 and over and 31% among people with annual household incomes of £7,000 or less. Previous Citizens Advice research found that not only do older people and those who are financially vulnerable do less shopping around than average, but they are also less responsive to prompts encouraging them to do more.<sup>41</sup>

Time is a key barrier to consumer engagement. In order to make well-informed decisions in essential service markets, consumers would need to almost double the amount of time they spend shopping around. One reason why consumers tend to engage less in essential service markets may be because they find the experience of engaging less enjoyable.<sup>42</sup> This research finds that even among those who would like to spend more time shopping around for essential services, only 2 in 5 say they have the time (16% of consumers overall).

**Figure 5: Most of those who would like to do more shopping around don't have the time to do so**



Together, these findings suggest that shopping around in essential service markets needs to be made much simpler and more straightforward. In addition, special attention needs to be paid to those who are struggling to engage and drive competition at all.

<sup>41</sup> Citizens Advice, [Against the Clock](#), 2016.

<sup>42</sup> Citizens Advice, [Against the Clock](#), 2016.

## b. Choosing to stick with a deal

“I think most providers charge less for new customers to get them to use their products, but once they hook you in, the prices are raised by a lot each year because they hope you won't have enough time to look for something better.”

### Key behavioural biases at this stage of the consumer journey

#### Inertia/Status quo bias

This describes people's tendency to stick with a previous decision or the default despite there being benefits from switching.<sup>43</sup> Inertia is one of the strongest forces in consumer behaviour, and it means that for some, switching will always be less preferable - even if it would save them money.

#### Overconfidence and optimism

People tend to overestimate their abilities and knowledge, leading to overconfidence and risky decision-making.<sup>44</sup> Those with least knowledge tend to be most overconfident.<sup>45</sup> Optimism leads people to overestimate the likelihood of a positive outcome and underestimate that of a negative one.<sup>46</sup> Around 30% of consumers overestimate their credit score. Consumers also tend to overestimate their ability to regularly pay off loans.<sup>47, 48</sup>

#### Temporal effects

Reminders are powerful, but timing is crucial.<sup>49</sup> Studies have found that individuals save more if reminded to at timely moments.<sup>50</sup> A recent study found that very high savings anchors were not very effective unless sent when people had just received bonuses, which increased savings rates.<sup>51</sup> People are also more likely to act at the start of a new month or year, or on a meaningful date like a birthday.<sup>52</sup>

<sup>43</sup> Samuelson & Zeckhauser, 1988; Wilson et al., 2005.

<sup>44</sup> Kahneman, D., & Tversky, A. On the reality of cognitive illusions. *Psychological Review*, 1996; Ho, C. M., Does Overconfidence Harm Individual Investors? *Asia-Pacific Journal of Financial Studies*, 2011.

<sup>45</sup> Lichtenstein, S., & Fischhoff, B. 'Do those who know more also know more about how much they know?' *Organizational Behavior and Human Performance*, 1977.

<sup>46</sup> Shepperd, J. A. et al., Exploring the causes of comparative optimism. *Psychologica belgica*, 2002.

<sup>47</sup> Perry, V. G. Is Ignorance Bliss? Consumer Accuracy in Judgments about Credit Ratings. *The Journal of Consumer Affairs*, 2008.

<sup>48</sup> Heidhues, P., & Hozzegi, B. Exploiting naivete about self-control in the credit market. *The American Economic Review*, 2010.

<sup>49</sup> Madrian, B. C. [Matching contributions and savings outcomes: a behavioral economics perspective](#). NBER Working Paper, 2012.

<sup>50</sup> Karlan, D. et al., Getting to the top of mind: How reminders increase saving. *Management Science*, 2016.

<sup>51</sup> Choi, J. et al., [Small cues change savings choices](#). National Bureau of Economic Research, 2012.

<sup>52</sup> Dai, H. et al., The Fresh Start Effect. *Management Science*, 2014.

Entering into a contract is not the only opportunity people have to exercise choice. There is also an opportunity for people to choose whether or not they stick with a provider. In competitive markets, this decision is proactive rather than one based on inertia. But this chapter highlights how providers take advantage of people's tendency to not shop around after they have taken out a contract by sending ineffective notifications which allow customers to automatically roll onto more expensive tariffs.

Energy, telecoms, and financial services contracts typically auto-renew or default onto a 'standard' tariff once the initial contract period has ended. This means that people do not need to shop around or make a decision in order to keep receiving the service. The benefit to consumers is that they are guaranteed continuous provision of essential services. The disadvantage is that consumers are not required to make the active choices that encourage competitive pricing, improved customer service, and innovative product development.



Jo came to Citizens Advice seeking help with her finances after the death of her father who had been ill for 25 years, and during which time Jo had helped with his care.

When examining Jo's documents, the adviser noticed that Jo's father had been paying £170 per month for buildings and contents insurance - £3,040 each year. The adviser thought this amount seemed unusually high compared to other household expenses and, upon investigating the policy, could find no reason for this.

Due to her own caring duties, Jo had not previously had the time to closely monitor ongoing contracts, or to shop around every time prices changed. She felt that her situation, and her father's ill health, had left them both vulnerable to being overcharged.

## Limited time prevents people from shopping around after entering a contract

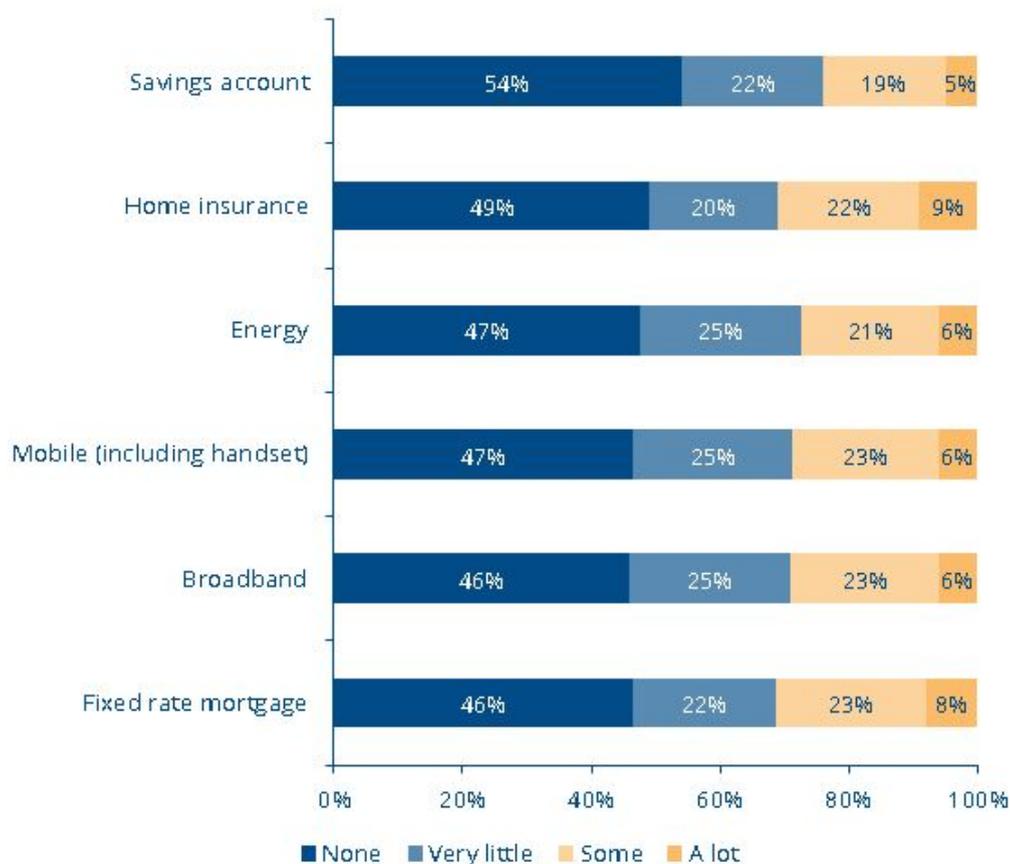
"The companies know we don't have the time to shop around so don't bother to give us the best deals."

Of course, making an active, informed choice to be a loyal customer would still help to drive competition. If people shopped around while in essential service contracts, companies would need to offer good value service in order to retain existing business. But inertia undermines competition because companies lose

incentives to offer good value services to existing customers who they know are unlikely to move.

The previous chapter highlighted that many people do little or no shopping around before entering into an essential services contract. Chart 4 below shows that people are even less likely to explore the market once they have entered into a contract. This should not come as a great surprise. Previous Citizens Advice research has shown that time is a key barrier to engagement, especially in essential service markets.<sup>53</sup> There is no reason why this should change after a consumer enters a contract. Having to do even more shopping around when you have already spent time picking the deal can feel even more frustrating.

**Chart 4: Most people do little or no shopping around while in essential service contracts**



Source: Citizens Advice analysis of Populus data<sup>54</sup>

<sup>53</sup>Citizens Advice, *Against the Clock*, 2016.

<sup>54</sup> ‘Since you began your current contract for the following essential services, how much shopping around did you do, if any, to examine the various options in the market?’ Bases vary by market.

## Notifications when initial deals expire are often ineffective

“I believe that long-standing customers are taken for granted and that these providers do not do enough to tell customers when better deals are available.”

Essential service providers can help people make active, informed choices to be loyal by sending their customers effective notifications to inform them when their initial deal is due to expire. This would prompt people to make the decision to remain with their current essential service provider or switch in search of a better deal.

An audit of providers shows that, when it comes to sending notifications, good practice is not consistent across essential services. Many providers don't notify their customers more than once or take steps to increase the effectiveness of their prompts. For example, in the home insurance and mortgage markets, letters are still used as the method of notification, and people are not invited to choose their preferred method of communication.



Saumya came to Citizens Advice after experiencing difficulty when her home insurance came up for renewal. She received a letter saying her yearly premium was being increased to £252 per year- an increase of over £200 from the previous year. Saumya rang her provider asking for an explanation of the increase. The provider could not provide an explanation, but offered to reduce the premium to £192 per year. Saumya said this was still too large an increase and that she would switch insurers. The provider then reduced the premium to £39 per year with a £50 excess, which Saumya accepted. Had she been away when the renewal letter arrived, she could have found herself renewing automatically at the new rate.

**Table 2: How essential service providers inform their customers that their initial contract is due to end<sup>55</sup>**

Market	Method	Notice	Frequency
<b>Broadband:</b> 4 of the 5 main providers remind customers their contract is due to expire <sup>56</sup>	3 out of 5 send email only; 1 also calls	1 month	1 notification
<b>Energy:</b> It is mandatory for providers to notify customers when their prices are about to change. <sup>57</sup>	Range of methods <sup>58</sup>	4-7 weeks	1-2 notifications <sup>59</sup>
<b>Home insurance:</b> it is now mandatory for insurance firms to notify customers before renewal <sup>60</sup>	Letter and email	At least 3 weeks <sup>61</sup>	1 notification
<b>Mobile (including handset):</b> 4 of the 7 main providers notify their customers that their contract is due to end. <sup>62</sup>	Email and text	30-60 days	1-2 notifications
<b>Mortgage:</b> It is mandatory for mortgage providers to give notice of interest rate changes. <sup>63</sup>	Letter	30-90 days	1 notification
<b>Savings:</b> All 6 main providers contact their customers before end of fixed rate period. <sup>64</sup>	Letter <sup>65</sup>	7-14 days	1-2 notifications

<sup>55</sup> See Appendix for explanation of how we selected the providers to audit.

<sup>56</sup> Citizens Advice, [Exploring the loyalty penalty in the broadband market](#), 2017.

<sup>57</sup> When asked via live chat, 1 provider told us they "cannot guarantee that this will happen".

<sup>58</sup> 2 of 5 send letters as default, unless customer has opted for paperless billing. 1 provider sends an email. Only 1 provider uses the mode of communication preferred by the customer, including a text option. 1 provider does not specify a notification method.

<sup>59</sup> 1 provider sends 2 notifications, and also sends an alert that appears on customers online accounts, remaining there for a month. 1 provider sends one notification, and also notifies customers when they have been moved to the SVT. The other 3 send one notification.

<sup>60</sup> The FCA recently proposed that firms disclose last year's premium on retail general insurance policies, and that customers who have been with an insurance provider for 5 years be prompted with a message encouraging them to shop around.

<sup>61</sup> Our researchers contacted 9 of the largest insurance providers in the UK and asked how they notify customers. All said they do so by letter, and all but one (who did not specify) said this would happen at least 21 days before the end of the contract. None of the providers mentioned other communication methods.

<sup>62</sup> 3 of the 7 main providers notify customers by email and text. 1 notifies customers on their online account. 2 automatically move customers to a cheaper tariff once their contract ends.

<sup>63</sup> [FCA Handbook](#). Mortgage providers must also provide an annual statement detailing payments due and made over the last year. All must be provided in a 'durable medium'.

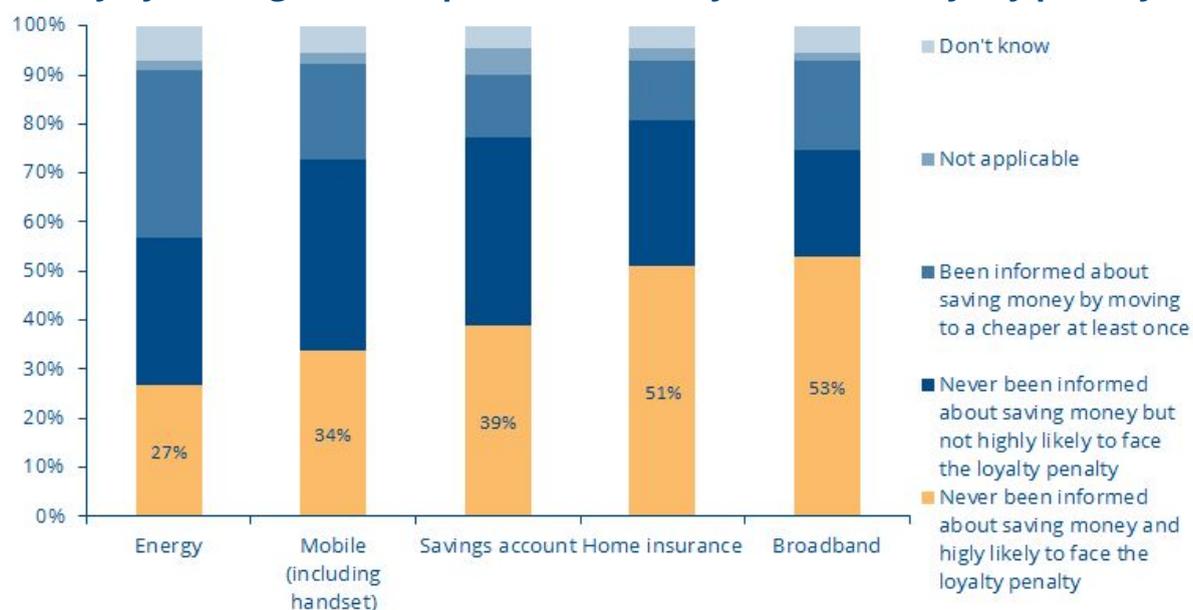
<sup>64</sup> 5 of 6 outline reinvestment options in communications.

<sup>65</sup> 3 out of 6 send letters; 3 out of 6 don't specify.

Providers' patchy and ineffective notifications have implications for consumers. Since people lead busy, complicated lives, they may not remember the exact dates they entered into contracts for the various essential services they receive. If a firm fails to remind its customers when their contracts are due to expire or informs them using ineffective communication methods, it is less likely that consumers will make a proactive choice to remain with their current provider or switch to another.

This research finds that, across essential services, most consumers are not aware of ever having been informed that they could save money by moving to a cheaper deal. More than half (57%) of consumers in the energy market and three quarters (75%) of broadband customers, for example, are not aware of ever being notified by their current provider. Not all of these people will have been in contracts for long enough to save money by moving to a cheaper deal. However, using a conservative estimate, many of those who have never been informed that they could save money are likely to face the the loyalty penalty, as Chart 5 below shows.

**Chart 5: Many of those not aware of being informed that they could save money by moving to a cheaper deal are likely to face the loyalty penalty<sup>66</sup>**



Source: Citizens Advice analysis of Populus data<sup>67</sup>

<sup>66</sup> We have not included the figures for fixed-rate mortgages because calculating the loyalty penalty in this market is more complicated (see Citizens Advice, [Exploring the loyalty penalty in the mortgage market](#), 2017). See Appendix for more detail on this conservative approach to identifying those likely to face the loyalty penalty.

<sup>67</sup> 'Since you began your current contract for the following essential services, how often, if at all, have you been informed by your provider that you could save money by moving to a different deal?' Base sizes vary by market. 'Not applicable' is intended to capture cases where the respondent has a contract in the relevant market but can't move because, for example, they are in over £500 of prepayment meter debt.

“I have never been offered any rewards, reductions or improved benefits after staying with suppliers for more than 50 years and at my age (82) I am worried about making changes as I do not trust what is on offer from other suppliers.”

This does not necessarily mean that providers are failing to inform most of their customers that cheaper tariffs are available. In markets such as energy, this is mandatory.<sup>68</sup> But it does suggest that, even when firms are notifying consumers, their communications are often ineffective.

### c. Choosing to exit a contract

“Service providers offer lower introductory offers for new customers, but poorer offers for existing customers, relying on the hassle of changing contracts to make more money out of us. Even if you move, you'll end up feeling that there are always better offers available elsewhere.”

#### Key behavioural biases at this stage of the consumer journey

##### Friction costs

Seemingly small barriers like tedious search processes, setting up a new account or calling your provider to cancel a contract can affect an individual's decision to follow through with a task - and may deter those in greatest need from completing it.<sup>69</sup> Every additional step required creates friction that might deter consumers from switching to a better deal.

Competition depends on consumers being able to move if they are not being provided with the best value service. However, at the moment, there are both financial and non-financial barriers to exiting essential service contracts. These frictions can encourage people to stay loyal even when they are penalised for it, leading to firms facing reduced incentives to improve products and services. What's more, our research finds that a significant proportion of those who list positive reasons for not exiting a contract, such as the belief they are on the best available deal, are likely to face a loyalty penalty.

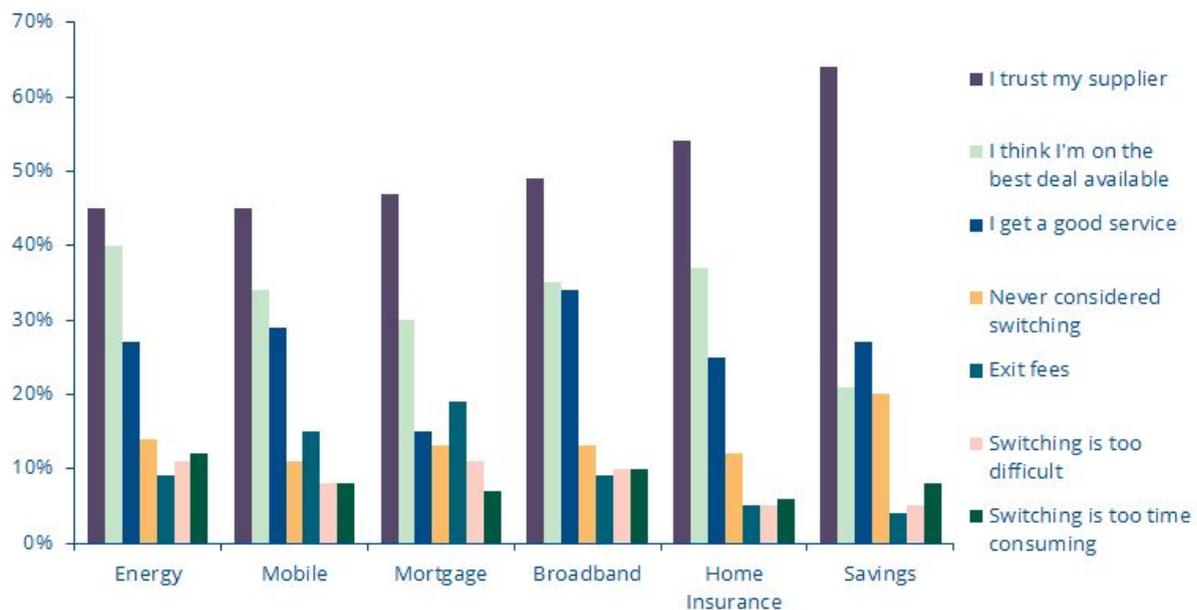
<sup>68</sup> Ofgem, 'From October energy suppliers must tell customers if their cheapest deal is marketed under a different brand', 2015. In the energy market, there are in fact 2 key requirements. The cheapest tariff message which appears on every bill, and the end of fixed term contract notification which only goes to people who have a fixed term contract. The way that these messages are presented is currently highly regulated by Ofgem, but work is being done to improve their effectiveness.

<sup>69</sup> Bettinger, E. P. et al., The Role of Application Assistance and Information in College Decisions. The Quarterly Journal of Economics, 2012; Currie, J. The Take Up of Social Benefits. National Bureau of Economic Research, 2004.

## Many people stay with their provider for positive reasons

The Competition and Markets Authority has found that people tend to trust their own banks and energy suppliers more than they trust others, and this may be a barrier to switching.<sup>70</sup> This report finds that trust is a barrier to leaving contracts across essential services. As Chart 6 shows, the most popular reason respondents chose for remaining on their current contract was 'I trust my provider', followed by 'I think I'm on the best deal available'.

**Chart 6: Trust is the most popular reason people give for staying in an essential service contract**



Source: Citizens Advice analysis of Populus data<sup>71</sup>

## But this loyalty is often misplaced

Since 2 in 5 people aren't aware of the loyalty penalty, it's perhaps unsurprising that trust and being on the best deal are two of the most common reasons listed by respondents. However, in many cases such perceptions may be misplaced. While 1 in 3 mobile handset customers stayed because they think they are on the best deal available, 61% of these people have been in their contract for longer than 2 years, and are therefore likely to be paying a loyalty penalty.<sup>72</sup>

<sup>70</sup> GfK for the CMA, [Personal Current Account Investigation](#) and [Energy Market Investigation](#), 2015.

<sup>71</sup> Question: 'You said you have been in your contract for a year or more. Why have you stayed with each of the following essential service contracts?' Respondents could select more than one option. Base sizes vary by market.

<sup>72</sup> We have used 2 years as the timescale here because the longest handset contract our researchers could find in this market was a 24 month contract. It is therefore very likely that anyone who has had a mobile handset contract for longer this is being overcharged. See Appendix for details.

**Figure 6: Many people stay in their mobile handset contracts because they mistakenly think that they are on the best deal available**



In fact, 1 in 3 people who are likely to face the loyalty penalty in the energy, mobile handset, broadband or home insurance markets, believe they are on the best deal available.<sup>73</sup> This suggests people don't have good reason to trust their supplier. Of the 49% of people who have remained in their current broadband contract because they trust their provider, 4 in 5 are likely to be paying a loyalty penalty.

**Figure 7: Most broadband customers who stay with their supplier because they trust them are likely to be paying the loyalty penalty**



<sup>73</sup> In the savings market, 16% of those who are likely to pay the loyalty penalty think they are on the best deal available. The sample size for the mortgage market was too small to be reliable.

## Difficulty and time taken to move are also factors

“I have the impression that they charge long-standing customers more than newer ones. But I'm too busy to change providers and worry that something will go wrong if I do.”

“I understand that special offers to attract new customers are an integral part of the marketing process, but sometimes it seems hard to stomach when you have been a loyal customer for many years and get no chance to enjoy these offers. Switching can be a hassle and I am reluctant to switch for a good offer as it means changing details e.g. mobile number or email address.”

Negative reasons were also cited by a significant minority of respondents. 1 in 5 respondents selected at least one negative reason for remaining on their energy, broadband or mobile handset contract.<sup>74</sup> And 18% of respondents cited ‘moving is too difficult’ as a reason for staying in at least one essential service contract.

The government has suggested principles that should inform the design of switching processes in essential service markets. These principles include speed, ease and the importance of the gaining provider leading the process.<sup>75</sup> Overall, 10% of respondents with a broadband contract and 8% of those with a mobile handset contract said they had stayed in part because moving was too time-consuming. This suggests that existing efforts to reduce switching frictions in telecoms markets have not been wholly successful.



Sam came to Citizens Advice for help reducing his energy bills. He didn't want to switch suppliers, or change to dual status with either of his current suppliers. His adviser contacted both suppliers to ask if he could go on a cheaper tariff. While the adviser was able to negotiate cheaper tariffs in both gas and energy, the amount of time taken to do so was over an hour for each supplier.

Sam is diabetic, and was getting hungry, thirsty and frustrated as the process went on. Had he not been supported by the adviser, it would have been very difficult for him to negotiate comparable deals.

<sup>74</sup> Negative reasons were ‘moving is too time consuming’, ‘moving is too difficult’ or ‘I don't want to pay an exit fee’.

<sup>75</sup> BIS, [Switching Principles: Next steps - action plan](#), May 2016.

Table 3 below shows the variety of financial and non-financial barriers that customers face across a range of essential service markets when exiting their deal after their initial deal expires. Where appropriate, we have clarified between switching deals and switching providers.

**Table 3: A range of barriers make it difficult to leave contracts even after the initial deal expires**

<b>Market</b>	<b>Financial barriers<sup>76</sup></b>	<b>Non-financial barriers</b>
Energy	No exit fees after initial deal expires	Time taken to find new deal Difficulty using price comparison websites
Broadband	Paying for a new router (if switching providers)	Loss of service Some companies require you to cancel over the phone
Mobile (including handset)	No exit fees after initial deal expires Handset unlocking fees have also been abolished	Hassle of unlocking phone and porting number Some companies require you to cancel over the phone <sup>77</sup> Risk of changing coverage (if switching providers)
Mortgages	Remortgaging fees - £0-£1,000	Remortgaging can be a lengthy and stressful process Difficult to secure a mortgage in the current climate
Home insurance	Consumers may lose their no-claims discount (if switching providers)	Different deals may offer different coverage, which could leave consumers unprotected Some people struggle to use price comparison websites unaided
Savings	No exit fees after initial deal expires	Hassle of setting up account (if switching providers)

<sup>76</sup> We chose not to include exit fees among financial barriers because these apply to the initial contracts people enter, not the 'standard' contracts they default onto. This report focuses on the cost of these default contracts and this chapter focuses on barriers to exiting them.

<sup>77</sup> [Ofcom's upcoming switching proposals](#) will require companies to allow text and online cancellation.

These barriers are likely to be felt most keenly by vulnerable people. While 1 in 5 (22%) of those without a mental health condition think it's difficult to exit an essential service contract, this rises to 31% among those currently experiencing a mental health condition. This, together with the earlier finding about difficulties shopping around, suggests that experiencing a mental health problem makes it harder to navigate complex essential service markets.<sup>78</sup>

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<sup>78</sup> For evidence showing the negative impact poor mental health has on financial capability, see The Money and Mental Health Policy Institute, [‘Seeing through the fog’: How mental health problems affect financial capability](#), 2017.

## 5. What does the loyalty penalty mean for the wider economy?

This report has focused primarily on the impact that the loyalty penalty has for consumers. But the fact that essential service providers are benefiting from people's behavioural biases also has important implications for the wider economy.

At the heart of the government's proposed industrial strategy is the ambition to create an environment in which challenger firms can grow, driving up innovation, productivity and competitiveness within their sectors.<sup>79</sup> This chapter shows that essential service providers are often heavily reliant on long-standing customers on expensive default tariffs, many of whom they know are unlikely to switch. This market structure favours incumbents rather than challengers and may reduce the incentives that firms have to innovate.

### Essential markets are dominated by large companies

Across essential markets, a small number of providers hold a large proportion of the overall market share.<sup>80</sup> These providers tend to dominate where services have previously operated under monopolies, such as telecoms and energy services, though the market share of incumbent suppliers is declining. And even in the savings account market where there are over 100 providers, over two thirds of the market is controlled by just 6 providers.

This research finds that people are likely to remain with the essential service provider they trust. It also highlights the power of behavioural biases which lead to difficulties shopping around, and steer people towards sticking with the status quo. Our audit of provider behaviour suggests that many dominant suppliers are exploiting these traits to ensure consumers remain loyal, thereby protecting their market share from competition.

### These companies are heavily reliant on loyal customers

Across essential markets, large numbers of people are paying more for the same product or service because they have remained loyal to their provider. For example, 12.9 million households auto-renew their home insurance after one

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<sup>79</sup> BEIS, [Building our Industrial Strategy](#), January 2017.

<sup>80</sup> See Appendix for more details. Each of the six markets explored in this research have Herfindal-Herschman Index scores of 1,000 or more which mean that they can be classified as 'concentrated', according to SMF, [Concentration not competition: the state of UK consumer markets](#), 2017

year, meaning they pay more expensive premiums. 12 million households are on the SVT in the energy market, accounting for 44%<sup>81</sup> of the market.

There is evidence to suggest that dominant essential service providers use their disproportionately high number of loyal customers to increase profits without having to compete. For example, the FCA has observed that '[insurance] providers have tried to increase profitability by...introducing dual pricing'.<sup>82</sup> This means that rather than competing through innovation or low prices, insurance providers are charging different prices to different customers for the same product.

Similar trends are also present in other essential service markets. In the energy market, a customer on an SVT is likely to be with the historical incumbent supplier. Average revenue from customers on the SVT is around 11% and 15% higher than average revenue from fixed electricity and gas tariffs across the Big Six.<sup>83</sup> And the FCA notes that in 2013, 17% of large providers' Cash ISA balances were held in accounts opened more than 5 years ago (compared to 5% for small and medium banks).<sup>84</sup> They also note that on average, the 4 largest current account providers pay lower interest rates on Cash ISA accounts than smaller providers.

## **Dominant providers may be profiting without innovating - and their ability to do so is likely to grow**

Well-functioning markets depend on companies competing to offer innovative new products, improved services and lower prices in order to keep and attract customers. In essential service markets, competition for those consumers who switch regularly can be fierce, especially on price. However, when a large portion of firms' profits come from loyal customers sitting on poor value deals, the competitive pressures companies face are undermined. Developing new products and attracting new customers becomes less important. Instead, companies find ways to charge long-standing consumers more in order to maximise the profits they generate. As a result, innovation, efficiency and productivity all suffer. Worse still, this problem may be set to increase. The advent of big data means price strategies are rapidly becoming more sophisticated.

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<sup>81</sup> This is number of households on the SVT as a proportion of all households in the UK according to the ONS, [Families and Household in the UK](#), 2016.

<sup>82</sup> [FCA sector views 2017](#).

<sup>83</sup> CMA, [Energy Market Investigation](#), 2016.

<sup>84</sup> FCA Cash Savings Market Study. 'Large providers' refers to the six providers with 68% market share. This trend is also present for easy access accounts. 33% of large providers' easy access balances were held in accounts opened more than 5 years ago, compared to 27% of small and medium banks' balances, and 23% of building societies' balances.

Switching customers should help keep prices down for everyone - providers have to treat every customer well in case they are a 'switcher'. But as larger providers, in particular, are increasingly able to target attractive prices at certain customers whilst keeping others on uncompetitive deals, the competitive pressures created by switchers increasingly do not bring benefits for everyone. By targeting advertising and collecting cookies, providers can gain huge levels of insight into individuals' willingness to pay and likelihood to switch.<sup>85</sup>

This trend does not just mean that those least able are likely to end up paying more.<sup>86</sup> It also further increases the power of incumbents with large market shares and prevents challengers from entering the market or growing their market share. Large, established providers are better able to engage in personalised pricing, keeping loyal customers on poor value deals while tempting 'switchers' with attractive prices. When this happens, even ostensibly competitive markets - with numerous suppliers offering a range of deals - may be failing.

This raises a number of pressing questions for regulators. How do competitive pressures apply when there is no longer one fixed price - or even several - but instead pricing is personalised according to people's characteristics? How can regulators encourage innovation while also protecting the vulnerable?

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<sup>85</sup> The Atlantic, ['How online shopping makes suckers of us all'](#), May 2017.

<sup>86</sup> For example, in the US there is evidence that auto-insurers use people's marital status to determine the increase in their renewal, hiking up prices for widows even though there is no evidence this is linked to risk. See Consumer Federation of America, ['New research shows that most major auto insurers vary prices considerably depending on marital status'](#), July 2015.

## 6. Conclusion

When consumer markets work well, people's spending can be a powerful force for good. But when consumer markets fail, these failures carry a heavy price. People experience rip-off deals, shoddy services, and scams that waste their time and money. And often it's the vulnerable who are hardest hit.

This report highlights how essential markets are not working effectively. Well-functioning markets run on choice - this is what drives competitive pressures. But this research shows how providers undermine consumer choice at each stage of the consumer journey, using processes which take advantage of people's behavioural biases. When companies profit from a lack of choice, this can lead to inefficiencies in the market.

But the loyalty penalty is not just inefficient, it's also unfair. Across a range of essential markets, time and time again, it is vulnerable people who are disproportionately stung. Older customers, those in lower income groups, and people without a university degree are more likely to face a loyalty penalty. And people with mental health problems are more likely to report difficulty accessing good deals. All of this is undermining faith in whether markets can deliver the right outcomes for consumers.

What can be done to address this problem? Since the early 2000s, UK regulators have developed and implemented a number of market remedies designed primarily to enhance competition by improving consumer decision-making. Over this period there has been a gradual shift in approach with regulators incorporating a more sophisticated understanding of behavioural science into their work,<sup>87</sup> and moving from 'empowering' consumers with information and other tools towards 'engaging' consumers by targeting the behavioural barriers that impede searching and switching.

Essential service markets are at varying points of experimentation with regulation designed to engage consumers and improve competition and consumer outcomes. These range from lighter touch remedies (for example, including cheapest tariff messaging on energy bills) to bolder market interventions that require significant changes from providers (for example, introducing a safeguard tariff for energy consumers on prepayment meters to protect them from overpaying due to weak competition).

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<sup>87</sup> Behavioural Insights Team for Citizens Advice, '[Applying behavioural insights to regulated markets](#)', May 2016.

This report sets out a number of opportunities to improve how essential service markets work for loyal consumers. The solutions are not necessarily the same for each market and instead reflect specific market characteristics, as well as the level and history of detriment.

## 1. Improve support and protections, especially for vulnerable customers:

- **Regulators should introduce targets for providers to reduce the loyalty penalty.** A bloated loyalty penalty in most markets is a sign of dysfunction. Regulators should monitor the size and breadth of the penalty in each market. They should then set providers targets for reducing its size and prevalence. Ofcom, for example, should require broadband companies to report how many of their customers are out of contract, how long they've been out of contract, and how much extra on average they are paying compared to in contract customers.<sup>88</sup> This data should be broken down by different demographic groups, including age and income. Gathering this information would ensure that policymakers are able to monitor the extent of the loyalty penalty in the the broadband market, and supply a substantial evidence base if further regulatory intervention becomes necessary.
- **Regulators should consider safeguard tariffs and investigate 'best deal' defaults for vulnerable customers.** Evidence shows that some groups struggle to shop around and drive competition. They need to be protected from extreme detriment. In the energy market, Ofgem have now recognised this and brought forward plans to protect a million low income vulnerable consumers this February. It plans to widen this to a larger group of vulnerable consumers by next winter, ahead of the whole market cap coming into place. Ofcom's intention to introduce price controls for standalone landline telephone services shows that it is also alive to this issue.<sup>89</sup> But compared to energy, the loyalty penalty in the broadband market represents a much steeper rise from the initial contract price, and the same vulnerable groups are likely to pay it.<sup>90</sup> Ofcom should therefore investigate ways to address the loyalty penalty in the broadband market. Solutions should reflect the evolving nature of the market but one option could be the possibility of introducing requirements on providers to offer vulnerable customers their most competitive deal. The FCA should also investigate how this could apply to

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<sup>88</sup> The Digital Economy Act 2017 significantly strengthened Ofcom's ability to monitor these problems. The Act gives the regulator the power to require telecoms companies to gather and share specific forms of information about their business.

<sup>89</sup> Ofcom, [Review of the market for standalone landline telephone services](#), 2017.

<sup>90</sup> Citizens Advice, [Exploring the loyalty penalty in the broadband market](#), 2017.

other financial services, looking in particular at the insurance and mortgage markets where vulnerable consumers experience high levels of detriment.<sup>91</sup>

- **Regulators should work together to develop a common approach to ensuring vulnerable groups do not end up on bad deals across essential markets.** Vulnerability can take many forms, some of which will be transient in nature (e.g. bereavement). But this research finds that there are some characteristics which are associated with a greater risk of facing the loyalty penalty across essential markets. It is possible to identify these traits while also recognising that there are additional forms of vulnerability that are less fixed. This will help ensure a coherent approach. Regulators should follow the example set by Ofgem and Ofwat, and think about tackling vulnerability in a joined-up way. The National Audit Office's recent report on vulnerable consumers<sup>92</sup> provides a good opportunity for regulators to reflect and work together on this, ideally via the UK Regulators Network. If regulators identify that common solutions are appropriate across markets - like safeguard tariffs - data sharing should not be a barrier to protecting consumers.
- **Regulators should investigate limiting the amount of time that consumers can be penalised for their loyalty.** Ofcom should require mobile phone providers to automatically move all customers on a postpay mobile handset contract to a cheaper tariff once they have paid for the cost of their phone. This is already done by O2 and Virgin Mobile as a matter of course, showing both that this is possible and that markets are already moving towards such a system. Other regulators should investigate the possibility of time limitations to the loyalty penalty. This could involve putting a consumer on a provider's most competitive deal, after they have stayed with the provider for two years after the end of their initial contract.
- **The Competition and Markets Authority should investigate the cross-cutting impacts of and solutions to the loyalty penalty, with a focus on vulnerable consumers.** Many of the recommendations in this report can be addressed by individual regulators or government departments. Given the cross-cutting nature of the loyalty penalty - with bespoke solutions needed in each market - the Competition and Markets Authority (CMA) should investigate how an approach to the loyalty penalty can be built more systematically into regulation of essential markets. If

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<sup>91</sup> Chartered Institute of Insurers, '[Consumer Vulnerability - how well is insurance responding?](#)', 2015.

<sup>92</sup> National Audit Office, '[Vulnerable consumers in regulated industries](#)', 2017.

regulators lack the power or the remit to tackle the loyalty penalty, this should be addressed.

**2. Providers must improve the way they present information in their advertising. The Advertising Standards Authority (ASA), working with essential service regulators, should build on their success banning misleading broadband adverts by ensuring good practice across markets. This should apply across channels and be informed by the following principles:**

- **Adverts should never be knowingly misleading.** The language that providers use can lead consumers to form an inaccurate impression of the product or service they are signing up for. This may not be intentional but once made aware of it providers should amend as appropriate. For example, variable tariffs should be renamed to reflect the fact that they do not represent the best value. In the mortgage market, the 'standard variable rate' label should be changed to better describe the nature of the contract. Changing the name, for instance to 'expired rate', could encourage mortgage holders to engage in the market. The same should be explored in relation to end-of-initial-contract deals in other markets including energy, telecoms, and financial services. The labelling should be consistent across markets and be user tested to ensure it is effective. Furthermore, regulators should investigate how language is used in communications across essential service markets to discourage consumer engagement. For example, testing whether the use of the label 'renewal date' leads to poor consumer outcomes by establishing loyalty as the default.
- **Pricing should be displayed in a transparent way.** Consumers should be able to see the full cost of their tariff, both in- and out-of-contract. For instance, the FCA should require mortgage lenders to include clear, upfront and standardised information about SVRs before agreeing a contract with a new customer. This should include the losses incurred when rolling onto an SVR and the possible gains from switching to a different deal.
- **Adverts should enable time-efficient decision-making.** Attention has rightly been paid to reducing the length of time it takes for essential services to be switched from one provider to another. But there has been less focus on the time required to find the right deal. Regulators should identify how long it should take for consumers to make a good decision about an essential service contract. Companies, including price

comparison websites and other intermediaries, should display these times prominently on their websites.

- **Information in adverts should reflect how consumers live and behave.** For example, given that broadband customers surveyed said they had been with their provider for 4 years on average, price comparison websites should make it easier for people to understand the likely costs of a contract over its lifetime. Similarly, official complaints data could be included to help consumers make better purchasing decisions. Regulators should test different display options to optimise effectiveness and keep complexity to a minimum.

### **3. Providers should be required to work with regulators to test timely nudges and send customers effective prompts and notifications:**

- **It should be mandatory for providers to send clear notifications when a contract is due to end.** Consumers should be able to choose the mode of communication providers use. Providers should also have multiple notifications as the default setting, allowing customers who do not wish to receive many reminders to opt out. As timing is crucial, notifications should be sent so that consumers are still able to switch if they want to, and regulators should conduct tests to identify when exactly prompts are most effective in each market. When notifying consumers that their contract is due to end, providers should build on this timely moment and send along a personalised 'best offer' and outline clearly how it differs from the old contract. The offer should also build on past usage patterns of the individual consumer. For example, if a mobile customer has consistently not used their full data allowance then a cheaper deal should be offered in line with their usage.
- **Providers should be required to send consumers periodic notices disclosing how prices have changed.** From April 2017, all firms in the general insurance market must disclose last year's premium at renewal, and send customers who have renewed four consecutive times an additional message reminding them that they could save money by shopping around. There is evidence that some providers are obscuring this information from consumers,<sup>93</sup> so the FCA should continue to act to ensure compliance across the insurance market. Regulators should examine how other markets, such as broadband or savings accounts, could adopt similar practices, and whether an element of market comparison should be included so consumers can see price trends across

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<sup>93</sup> BBC, [Insurers 'burying price rises' in renewal letters](#), November 2017

the market. Because not all markets have 'renewal' dates, the frequency of notifications should be tested to identify the most effective form of disclosure. The format (e.g. graphs, monetary values, percentage changes) and pricing period (e.g. monthly, yearly, average lifetime of contract) should also be tested for effectiveness.

#### **4. Providers and regulators need to make it much easier for people to exit deals across essential markets:**

- **Providers should commit to ensuring the same method used to enter a contract is available to customers who want to exit.** Some essential service providers require consumers to cancel their contract over the phone, even though they may have been able to sign up online. This adds friction to the switching process. Regulators should encourage the adoption of this 'easy exit' practice and monitor how many providers take it up.
- **Ofcom should introduce provider-led switching in the mobile handset market.** This is already standard practice for financial services like savings and current accounts, and should apply more consistently across essential service markets. This is particularly important in telecoms markets where slow switching processes cause a high level of detriment.
- **Providers should automatically unlock mobile phones once the customer is outside of the initial contract period.** Having to unlock a mobile at the end of the initial contract period adds friction to the process of switching provider. The practice is especially hard to justify given that the consumer will have paid off the cost of the phone by that time. The government recently came to agreement with providers to scrap phone unlocking charges, but Ofcom should encourage providers to go further to ensure healthy competition in the market.
- **Regulators should investigate other barriers to switching.** Regulators should consider whether factors such as lengthy service outages and complicated sign-up processes discourage switching. If evidence exists, appropriate action should be taken. In addition, the FCA should research how the complexity of remortgaging fees deters people. The complexity can make it difficult for mortgage holders to exercise choice in the market, leading them to stay in uncompetitive deals.

## 5. Regulators should encourage the use of data and digital tools which help consumers to get a better deal:

- **Providers should be required to publish data showing the prices their customers pay by the length of time they have been in their contract.** The FCA recently found that consumers who have been with the same home insurer for 5 years pay on average 70% more than a new customer. Making equivalent data available across essential services would increase transparency for the consumer and provide an incentive for providers to improve their service, by making efforts to increase the proportion of customers on good value deals.
- **Providers should be required to make available secure machine-readable consumer data to help consumers find products that are best for their usage.** The CMA have recently introduced this in the retail banking market via the Open Banking Initiative, but it should apply across essential markets. Ideally this would be through Application Programming Interfaces (API) which any application or service could access with permission. This enables intermediaries to give consumers more personalised, low cost advice across a range of markets. The infrastructure for this was put in place through the midata initiative.<sup>94</sup>
- **Regulators should monitor the development of third parties which could take much of the hassle out of finding and switching to a better deal.** As well as price comparison websites, these include sites such as Cheap Energy Club which allows consumers to sign up to be notified if there is a better deal available for them, or Flipper which is a paid for automatic switching service. Regulators should explore whether, and if so how, this model could be supported and applied across essential markets. In addition, government and regulators should investigate what needs to be done to ensure those consumers who could most benefit from these services are able to use them.<sup>95</sup> This could include additional support both through investment and in supporting organisations like Citizens Advice to allow these tools to reach scale.

The aim of this report is not to end the loyalty penalty. In a competitive market, people should be given incentives to switch. But it shows the extent to which the playing field is tilted away from consumers. If people are to regain faith in markets, we need to change how we judge a 'well functioning' market.

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<sup>94</sup> BIS, [The midata vision of consumer empowerment](#), 2011.

<sup>95</sup> For more on how to increase the take-up of automatic switching services, see Citizens Advice, [Why we're spending £2 billion more than we need to on everyday services](#), August 2017.

The government should continue monitoring the detriment loyal customers experience across essential markets. Just as the government has asked Ofgem to take action in the energy market and signalled that it is willing to legislate if necessary, the government should be willing to take action in other markets if practices do not substantially improve.

The challenge is one for the broader economy, not just individual consumers. The presence of dominant providers with large proportions of loyal customers in a range of essential markets may suggest that a few firms are wielding outsized market power. With technology increasing the potential for personalised pricing, the government should remain vigilant as to whether the loyalty penalty is a symptom of an economy in which incumbents lack sufficient incentives to innovate and challengers are unable to thrive.

# Appendix

## Calculating the loyalty penalty

Market	Penalty	Definition
Energy	£110 <sup>96</sup>	Average gap between the standard variable tariff (SVT) and the cheapest deal for a medium user on dual fuel, weighted in line with the number of SVT dual fuel accounts
Mobile (including handset)	£264 <sup>97</sup>	Amount overpaid when people remain on a contract after they have paid for the handset, if paying the average monthly penalty
Broadband	£113 <sup>98</sup>	Difference between the cheapest basic broadband contract and the price customers pay after the initial contract period ends
Home insurance	£5 for contents insurance £13 for combined <sup>99</sup>	Average difference between the initial price a customer pays, and the price offered on renewal after 1 year. This penalty increases over time.
Mortgages	£439 <sup>100</sup>	Difference between the amount an average customer pays after they are moved from a 2 year fixed mortgage to a Standard Variable Rate (SVR), and the amount they would pay as a new customer with a fixed rate
Savings	£48 <sup>101</sup>	Difference between interest earned on a 1 year fixed rate cash ISA taken out in March 2016, and the interest earned when moved to a variable rate in March 2017.

<sup>96</sup> Calculated by Citizens Advice using [Ofgem price data](#) (British Gas, SSE, EON, NPower, Scottish Power, EDF, Co-operative, Ovo and Utility Warehouse), and information request data.

<sup>97</sup> Citizens Advice, [Mobile phone networks overcharging loyal customers by up to £38 a month](#), 2017.

<sup>98</sup> Citizens Advice, [Exploring the loyalty penalty in the broadband market](#), April 2017.

<sup>99</sup> Calculated by Citizens Advice using data requested from the FCA study, [Occasional Paper No. 22](#), September 2016, together with the [AA British Insurance Premium Index](#), Q3 2017.

<sup>100</sup> Calculated by Citizens Advice. Full outline of methodology can be found in our mortgage loyalty penalty policy note.

<sup>101</sup> Calculated by Citizens Advice using average variable and 1 year fixed cash ISA monthly interest rates from March 2017, as published by the [Bank of England](#), and the average balance in ISA accounts as published by [HMRC](#).

## Identifying those likely to face a loyalty penalty

A Citizens Advice researcher attempted to find the longest fixed term contract available in each of the markets assessed in this report. Where many different contract lengths were available, the longest period was chosen, even if many providers only offer shorter length contracts.

This is a conservative approach to estimating the scale of the penalty. Some people will have taken out contracts that are shorter than the maximum available in a particular market, and will subsequently have defaulted onto a poor value deal. These people are not identified by this report's calculations.

<b>Market</b>	<b>Maximum contract length (years)</b>	<b>Details</b>
Energy	4	Npower had the longest fixed tariff contract length our researcher could find
Mobile (including handset)	2	Regulatory requirement under the EU telecoms package: no consumer contracts can be more than 24 months. <sup>102</sup>
Broadband	2	Longest basic broadband contract length
Home insurance	1	Searched for quotes on price comparison websites. All quotes received were for 1 year contracts.
Mortgage	10	Although 2 year fixed and 5 year fixed mortgages are more common, it is possible to get 10 year fixed mortgages.
Savings account	10	Most common fixed term period across the main banking providers is a 2 year fixed rate cash ISA.

<sup>102</sup> European Commission, [Digital single market: user's rights](#), accessed 22/08/2017.

## Auditing provider information and behaviour

To audit provider behaviour and advertising of the loyalty penalty, we looked at how the price of essential service contracts after the initial period is advertised on providers' websites. For the purposes of this research, we audited the behaviour of the dominant providers across markets, as outlined in the table below.<sup>103</sup>

For providers across the 6 markets, we looked at the webpage where the out-of-contract price is displayed, the number of times a customer has to click to get there from the page where the initial price is first advertised. We also looked for information regarding provider behaviour when tariffs come to an end.

Market	Dominant providers	% market share
Broadband	5	91% <sup>104</sup>
Mobile (including handset)	4	86% <sup>105</sup>
Energy	6	82% <sup>106</sup>
Savings	6	69% <sup>107</sup>
Mortgages	6	69% <sup>108</sup>
Insurance	5	57% <sup>109</sup>

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<sup>103</sup> The exception to this is the mobile contract (including handset) market. While 4 providers have the largest proportion of market share, for the purposes of this investigation we audited the 7 largest mobile service providers in the UK as included in Ofcom's complaints bulletin. This was to ensure comprehensive cover of the market in line with best practice.

<sup>104</sup> Ofcom, [The Communications Market Report](#), 2016. This is share of residential and SME broadband services. The providers are Virgin Media, EE, BT, Talk Talk and Sky.

<sup>105</sup> Ofcom, [The Communications Market Report](#), 2016. This is share of retail mobile subscriptions. The providers are Vodafone, O2, EE and Three.

<sup>106</sup> Ofgem, [Electricity supply market shares by company](#), 2017.

<sup>107</sup> CMA [retail banking market investigation](#), 2016.

<sup>108</sup> [Council of Mortgage Lenders](#), 2015.

<sup>109</sup> Statista, [Market share of five leading general insurance companies based on gross written premiums value in selected lines of insurance business in the United Kingdom \(UK\) in 2013 and 2014](#).

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