Stick or Switch?

Making markets fairer and more competitive

Nigel Keohane

Social Market Foundation

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EXECUTIVE SUMMARY

The 'fair markets' agenda forms a major truss of the Government's domestic policy programme. And, rightly so: too many people feel they are being ripped off and poorer households in particular are vulnerable to unfairly high prices and unfavourable contracts. In a period of falling real wages, how households spend their disposable incomes becomes ever more important.

The Queen's Speech sets out a commitment to 'ensure fairer markets for consumers', including publishing a green paper that 'will closely examine markets which are not working fairly for consumers'.[1] The Government has already indicated its intention to intervene in specific markets, including writing to Ofgem and asking it to assess what action it can take to safeguard energy customers on the poorest value tariffs and consider the future of Standard Variable Tariffs. It has also committed to improving billing in telecoms.[2]

At the heart of the debate is concern about the outcomes for consumers who don't switch but stick with their suppliers and subsequently pay a so-called 'loyalty penalty'. This report focuses on such 'loyal' consumers and asks the questions: what do we mean by 'loyalty' in a market setting? And is it possible to help such consumers get a better deal without undermining competition in the market more generally?

The costs of sticking

Evidence suggests that those who 'stick' incur a penalty across a range of markets: it costs an average of £92 if you stay when your mobile contract ends; £300 extra if you are on a Standard Variable Tariff (SVT) in energy; and, £113 more if you stick with a broadband provider after your initial contract has ended.

Our polling reveals that the proportion of consumers who 'stick' with their provider over a three-year period is significant across a range of markets, including telecoms, energy and insurance. Only in car insurance do half of individuals report switching in the last three years. Switching levels are particularly low in home phone and mobile phone.

Developing concepts of 'loyalty'

Our research shows that 'Stickers' (non-switchers) are not a homogenous group. Behaviours of 'Stickers' cover a broad spectrum of market engagement: the 'Active loyal' engage with the market and may make a positive decision to stick with their provider and / or product; on the other extreme the 'Inactive' are disengaged from the market and inert. Our polling reveals:

- A majority of 'Stickers' report positive reasons for not-switching but a significant minority report negative reasons such as the hassle or risks associated with switching.
- Many 'Stickers' have switched their product or plan over the past three years, even though they've stayed with their supplier.
- A majority of all consumers have switched their provider or their product in the last three years except in the home phone market. This, however, leaves many who have done neither.
- Some 'Stickers' have tested the market in other ways such as checking price comparison websites, but this leaves a majority who have not.

This evidence provides encouragement that engagement levels are not as low as headline switching levels would suggest and evidence that some consumers may display 'active loyalty' to providers. Switching is one form of engagement, but other forms matter as well, helping consumers secure value and applying competitive pressure to the market. It also puts into relief the challenge: some are not engaged at all, and require activation.

How to respond

This paper argues that regulators and policymakers need to reach for a broader toolkit and more imaginative interventions to maximise engagement and competition in the market. We set out ideas to improve the deal that 'stickers' receive, to reduce the risk of a 'loyalty penalty' and to protect those who remain inert.

- Putting social pressure on suppliers by requiring them to display and publicise the proportion of their consumers who are on standard variable tariffs or out-of-contract products across energy, mobile, broadband and insurance.
- Setting suppliers targets to reduce the proportion of their consumers on variable tariffs. In energy, we propose that suppliers could be required to reduce the proportion of consumers on SVTs to 30% by 2020. Those suppliers that do not hit these targets should face a substantial fine. This would encourage providers to engage their consumers. While this may have some implications for the offers that providers make available to 'switchers' it would not have the accompanying downsides of the price cap.
- Requiring that all deals are available to existing customers as well as new customers.
- Requiring suppliers to explicitly reveal the costs of staying loyal with this information featuring on bills, statements and websites.
- Introducing a 'Default Collective Auction' for energy consumers who have not switched their supplier or plan in the past three years. The energy requirements of these consumers would be sold off through a bidding process. This would have the benefit of encouraging providers to actively engage their customers and move them onto better deals otherwise they would risk losing them. We propose that this should initially be pursued as an 'Opt-in' scheme, but that the regulator should also explore the potential of an 'Opt-out' scheme.
- Devising measures to introduce alongside any price cap, including setting a clear end date for the cap and implementing pro-market measures (as set out above) which can drive competition and engagement.

CHAPTER 1: WHY WE NEED TO ADDRESS THE QUESTION OF 'LOYALTY'

> *'My Government will ensure fairer markets for consumers.'*
>
> **Queen's** Speech, 21 June 2017

> *'Energy companies should treat all of their customers fairly – not just those who switch between suppliers.'*
>
> **Greg Clark MP**, Secretary of State for Business, Energy and Industrial Strategy, 16 November 2016

Consumer markets have shot to the top of the political agenda following the recent announcement that the new Conservative Government will introduce measures to help tackle unfair practices in the energy market. A potential price cap has proved a particularly controversial proposal receiving support in some quarters and opposition in others. More fundamentally, it motivates a wider discussion: how can we ensure that all consumers, not just those who regularly switch providers, get a good deal? Who are the loyal consumers in different markets and are they getting a good deal? And what can we do to help them?

With the Government set to publish a 'Fair Markets' Green Paper in 2017, now is an important moment to gain a deeper understanding of consumer behaviour and assess how well markets are functioning for those that stick with their suppliers.

Importance of consumer markets

Individuals and households access a range of core services from consumer markets, including basic utilities such as energy and water, financial services such as insurance, and telecommunication and entertainment services. They also spend a significant portion of their disposable income on these services and products,[3] with lower income households spending a higher proportion of their income on such necessities.[4] Whether households get a good deal in these markets can make a substantial difference to their quality of life.

Loyal consumers getting a poor deal

However, there is mounting evidence that outcomes across many of these markets are very mixed and the results for particular consumer segments poor. In particular, there has been growing political, media and regulatory focus on the outcomes for 'loyal' consumers or those who do not regularly switch their provider. While the traditional focus has been on switching, the majority of consumers 'stick'. As the Conservative manifesto suggests, 'customers trust established brands and mistakenly assume their loyalty is rewarded'.

The problem of inactive consumers receiving a poor deal is a challenge across a range of consumer markets, and recent qualitative research for Ofcom reveals that some consumers feel that there is 'no reward for loyalty anymore'.[5]

As Table 1 shows, the costs of renewing or sticking with your provider can be very high.

Table 1: The 'loyalty' penalty across markets

Mobile phone	Which? has revealed that half of consumers could save an average of £92 a year by switching immediately after their mobile contract ends.[6]
Energy	Research from 2016 showed that two thirds of energy consumers remain on their provider's Standard Variable Tariff, with Ofgem and Citizens Advice estimating that such deals typically costing £300 more than the cheapest fixed-rate tariff.[7]
Landline phone	Ofcom has recently concluded that BT landline-only consumers – who are often older and have stuck with their provider for decades – are getting a poor deal. Their review concluded that 'their loyalty to their suppliers is leading to ever higher prices'.[8] Ofcom is imposing a tariff cut for such customers of between £5 and £7.
Mortgages	An estimated 3 million UK mortgage loan borrowers roll-off their fixed-rate deal on to their lender's standard variable rate paying an average interest rate of 4.6% when some loans are available at around 1%.[9]

Broadband	Recent Citizens Advice research has revealed that broadband customers face an average penalty of £113 for each year they stay in their contracts after their initial contract period ends. This equates to a 43% increase on the initial price.[10]
Insurance	Data collected by Consumer Intelligence found that drivers could save £63 if they switched insurers after a year. Those buying home insurance could save £37.[11] Firms have come under pressure to stop their practices of increasing premiums significantly for customers that renew.

Such problems occur for a range of reasons. Standard tariffs (for instance in energy and mortgages) do not feel the same competitive pressure as other tariffs. Where the threat of switching is low, firms may be able to identify consumers less likely to switch and charge them higher rates. The drive to win market share sees firms offer a wider range of deals to attract new customers including discounts on prices in the first year, joining bonuses and fixed-term deals across energy, insurance, banking and telecoms. Providers may offer special deals only to new customers and not to existing customers. Inactive consumers may end up subsidising the offers made available to more active consumers.

Specific consumer groups – including some vulnerable groups, such as older people and those on low incomes – may be particularly exposed to these practices. Many consumers are unaware that such practices exist: a Citizens Advice survey found that a third of consumers believed that longstanding consumers of broadband services pay the same or less as new consumers, despite actually paying far more.[12]

Shifting the focus: looking beyond headline switching

Despite growing recognition of this problem, there has been little analysis to understand in more depth the behaviour of the loyal across consumer markets, to understand what loyalty means in the context of markets and whether government should do more to help.

In part this stems from a policy emphasis on switching. In the recent past government policy and regulation has focused on encouraging consumer switching as a means of enabling people to get the best deals in the market and of driving competition. This has brought some modest successes. Annual switching levels have increased in the energy market from 11% to 12% (electricity) and 11% to 13% (gas) between 2014 and 2015.[13] The proportion of consumers who have switched their current account at least once in the last five years has doubled since 2006 to 26%.[14] However, progress has generally been slow and modest.[15] A different mode of reform is needed. Other SMF reports have shown that who switches matters as much as headline switching rates.[16] Meanwhile, focusing only on switching may also ignore other important market dynamics – in current accounts, a significant minority 'multi-bank', holding accounts with more than one institution, testing out what is on offer without switching and using a wider range of services.[17] Other forms of engagement in the market such as switching product or testing the market are under-explored.[18]

A second factor that has halted progress is that any intervention must carefully strike a difficult balance: providing incentives for consumers to switch, whilst at the same ensuring good outcomes for other consumers. But, if the energy price cap arguably does not successfully strike this balance, it has revealed the political and public appetite to address the problem.

Helping consumers who do not switch to get a better deal is important. By identifying the types of behaviours among the non-switching groups, we can better understand whether and how they make decisions and influence markets. For instance, those who are 'actively loyal' to their provider may require different policy measures to assist them compared with those who are inert. While we acknowledge that each market has its own features and idiosyncrasies that may affect outcomes for switchers and loyal consumers, we believe that cross-market analysis can also help to gain a deeper understanding of consumer behaviour and possible remedies.

Chapter 2 analyses the characteristics and behaviours of 'stickers' (consumers who do not switch providers) and assesses the difference between 'actively loyal' consumers and the 'inactive' and inert.

THIS RESEARCH

This research seeks to answer the following questions:

- How do switching and 'sticking' rates vary across major consumer markets? And what explains these variations?
- To what extent do 'stickers' (non-switchers) engage in the market? And can we observe consumers who stick for reasons of loyalty rather than inertia?
- Which groups of non-switchers should policymakers worry most about?
- What should we do to help them?

METHODS

The research draws on a range of sources and approaches, including:

- Literature review of academic, policy and regulatory sources.
- Data gathered from regulators and other sources on switching behaviours.
- An online consumer poll of 2,079 UK adults carried out by Populus between 24th and 26th March 2017. The results have been weighted to be nationally representative of the UK population. We report the weighted results.
- A roundtable discussion with experts, industry, consumer representatives, regulators and policymakers.

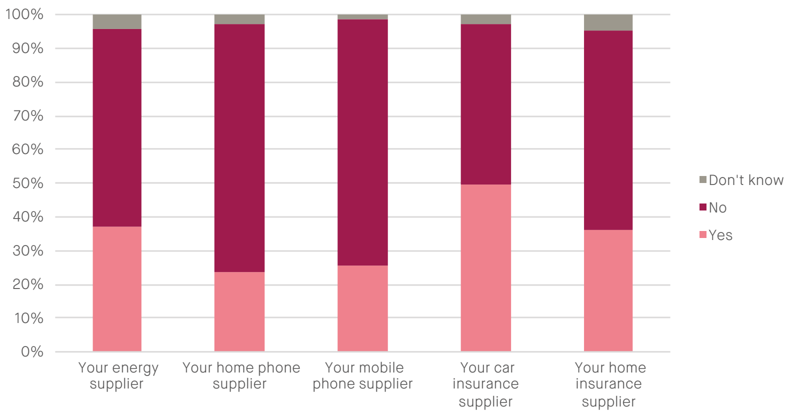
CHAPTER 2: ANALYSIS OF CONSUMER BEHAVIOUR IN MARKETS

This section starts by looking at switching levels across markets before looking in greater depth at those who 'stick', their demographics and their behaviours.

1. 'STICKING' VS SWITCHING

Switching and 'sticking' levels vary significantly by market reflecting inherent structural differences as well as consumer sentiment and behaviour. As Figure 1 shows, a majority of people have not switched their provider in the last three years across four of the five markets we analyse. The exception is car insurance where half of respondents (50%) report having switched during this period. In contrast, the home phone market shows the lowest level of switching, with just a quarter (23%) of respondents reporting that they have switched. Switching rates in the energy market sit mid-way in between with four in ten consumers moving provider in the last three years. It should be noted that our survey was an online poll and therefore displays slightly higher levels of switching than telephone surveys typically find.[19]

Figure 1: Have you switched any of the following in the past 3 years?



Source: Populus Survey for the SMF, excludes those respondents whom say 'not applicable'

A range of factors help to explain the differences across markets. Consumer perceptions of choice as well as satisfaction with providers contribute.[20] The level of product differentiation and the presence of in-built 'trigger points' also have effects.[21] For instance, while insurance markets have an annual renewal window, telecoms contracts are typically taken on minimum contract terms. Specific market features play an important part as Table 2 demonstrates.

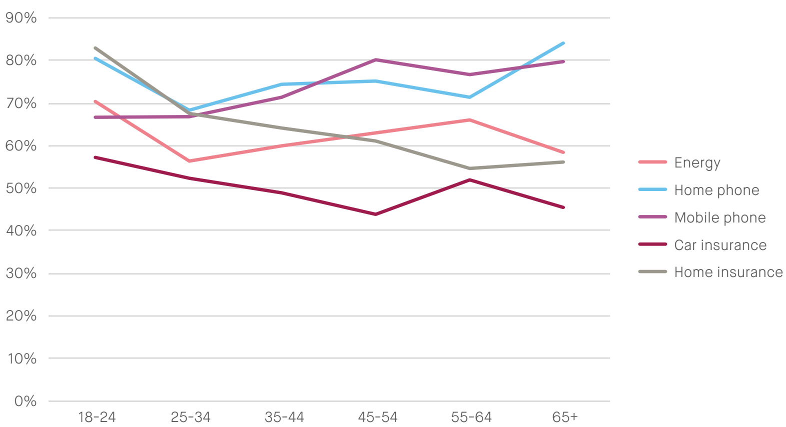
Table 2: Differences in features across markets: Sticking and switching

Market	Mechanism for switching	Regulatory focus
Energy	Consumers are usually moved to a standard variable tariff automatically once their fixed rate tariffs expire. Fixed rate tariffs usually run for 1 or two years. There is a natural trigger only when moving home (this is more likely to affect young individuals who move home more frequently).	The CMA review published in 2016 proposed a suite of market-based remedies. However, the recent focus on switching has turned to price caps.
Home Phone	Contracts usually run for 18 months, after which consumers typically stay on their original tariff.	Ofcom reports have focused on quality of provision and customer service; switching rates are low and Ofcom is introducing a price reduction for landline-only services.
Mobile Phone	Currently a lengthy process for monthly pay customers who wish to transfer their mobile number to a new network. Contracts do not automatically finish and consumers often fall into poor value deals when contracts end. The market has added complexity because devices are often bundled into the price of the service.	Ofcom are consulting on their final proposals for simplifying switching, including a recommendation to remove the need for consumers to communicate with their old provider.
Insurance markets	There is a natural trigger in the insurance markets as contracts only last for a year and have to be renewed, though it is possible for contracts to auto-renew in vehicle insurance.	FCA has been concerned about auto-renewal price hikes. All insurers must now reveal the price of last year's premium.

Demographics of 'stickers'

Past analysis by regulators and academics has shown that particular demographic groups are more likely to be 'stickers' than others although there are significant variations across markets. As Figure 2 shows, some age groups are more likely to 'stick' than others. In many markets, older consumers and young consumers are more likely to stick than middle-aged consumers. Ofgem research found that both under-35s and over-65s are more likely to be in their disengaged (or 'unplugged') group.[22] In contrast, an Ofcom report found younger people outperforming their middle-aged counterparts in some services.[23] Our survey shows older consumers switching less within both home and mobile phone markets.[24] This trend, however, is reversed when looking at the insurance markets. In the energy markets, too, the youngest group are less likely to switch. The fact that our poll was carried out online may mean that some older individuals who are digitally inactive may not be represented fully.

Figure 2: 'Sticking' rates by age demographic



Source: Populus Survey for the SMF, excludes those respondents who say 'not applicable' and 'don't know'

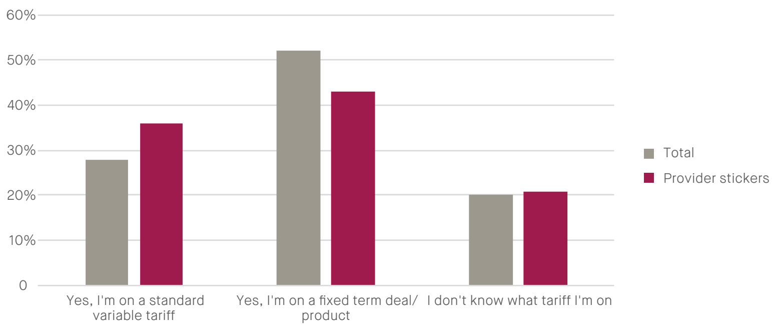
Data tends to be more consistent around socio-economic differences. Past SMF research has shown that 'sticking' rates in energy and telecoms tend to be higher among lower income groups than among higher income groups.[25] Our survey and research by others suggests that lower socio-economic groups are more likely to be disengaged generally in markets.[26] Understanding the background of consumers in particular markets can also help explain different types of engagement. We know for example that car owners tend to be better-off than non-car owners. This may help explain high levels of switching. Other research has found that pensioners are twice as likely as younger customers to have been on the same broadband contract for over 10 years, which typically comes with higher charges.[27]

Outcomes for 'switchers' and 'stickers'

As detailed in Chapter 1, outcomes for 'stickers' and 'switchers' differ markedly. Those who remain with suppliers can be defaulted onto more expensive contracts and be offered more expensive deals than new customers. The penalty can be high.

While we cannot observe actual value for money because we do not have data on consumers' usage or the quality of the service they receive, we are able to look at proxy outcomes, including whether consumers are on a Standard Variable Tariff in energy. Consumers on a standard variable tariff typically pay more than their counterparts on fixed term deals (Ofgem suggests around £300 more than the best deal).

Figure 3: 'Do you know which energy tariff you are on with your energy supplier?'



Source: Populus Survey for the SMF

The graph above shows that in our survey sample 36% of energy 'stickers' report being on a standard variable tariff, compared to the average of only 28% across our whole sample. Meanwhile, a fifth of respondents report not knowing what sort of tariff they are on. This implies that on average outcomes for 'stickers' are worse. It is notable, however, that a significant proportion report being on a fixed term product. This may reflect the fact that some may have switched their plan with the same supplier. It may also be the case that some are also mis-reporting the tariff they are on (for instance by electing not to admit to their disengagement).

2. 'STICKERS': UNDERSTANDING CONSUMER LOYALTY AND ENGAGEMENT

The section above described the market dynamics that may affect the proportion that 'stick' or 'switch' across different markets, the demographics of those that 'stick' with their provider and outcomes for 'stickers'.

However, switching provider is just one dimension of engagement in the market. This section sets out why we should think more carefully about the behaviour of those who 'stick'; it then explores how such consumers behave across a range of markets.

Developing a broader concept of engagement and loyalty

Switching levels matter in consumer markets for two reasons. First, those who switch are more likely to have tested the range of options available in the market and selected a service or product that fits their needs at the best cost. Second, the threat of switching forces providers to offer competitive deals to incumbent customers whilst encouraging providers to innovate and compete for new customers.

Theoretically, other forms of engagement in the market matter for the same reasons – those who engage may be more likely to get a product and a service that suits their needs at a good price; meanwhile, by engaging in the market consumers may either directly exert competitive pressure on providers or at the least be better-placed to exert pressure. Understanding the behaviour of 'stickers' is therefore important to assessing how well markets are working, to identifying groups of consumers that we should be concerned about and for developing appropriate policy interventions.

Among consumers who do not switch there are two broad camps, although within these groups there is also significant diversity of behaviour. Ultimately, consumers in different groups display different behaviours along the consumer journey. Past analyses have shown that in order to drive competition, consumers have to: be motivated to assess the market; have access to the information to make an informed choice; assess the options in a well-reasoned way; and, act.[28]

'Active loyal'	'Inactive'
Those who engage with the market and make a positive decision to stick with their provider and / or product. We expect that these consumers may be applying some pressure on their provider and driving competition. They may prioritise a different set of product or service features compared to Switchers, focusing on the emotional value to service and its quality. They may put weight on the trust they have in their current provider. Nonetheless, they are aware of other options in the market. Research by Bristol University has characterised a 'trust loop', where consumers' level of trust and loyalty to their current suppliers increases over time.[29] Some in this group may display risk aversion and put a price on reliability of staying with their current provider. They may also find satisfaction in associating themselves with the image of the provider – for example, the idea of having the best. **Behaviours may include:** Switching product or plan with the same provider; engaging with the market to look at the best options; using price comparison websites; contacting their own supplier to ask for a better deal.	This group stick with their provider but not necessarily out of choice. It is made up of at least two sub-sets: **'Frustrated consumers':** Those who would like to be active in the market but are deterred for one reason or another, such as the costs or risks associated with switching. These are described in the literature as 'behaviourally loyal' – in other words their ultimate behaviour may be to look loyal but they would rather not 'stick'. **Behaviours may include:** desire to switch but lack of ability to switch. **'Inert or disengaged consumers':** The inert are 'stickers' who have not taken any action because they are disengaged. Such consumers do not switch in order to achieve their consumer preferences. They are often unaware of their options (what Ofgem has termed 'unplugged'). In exceptional cases they may be insensitive to price or quality. More likely, they are unaware of the choices available to them, display an indifferent attitude to engagement in the market and / or lack the ability to take decisions and act.[30] They may also display the 'Ostrich phenomenon': namely not wish to know that they are getting a bad deal. **Behaviours include:** inaction

Below we explore four dimensions of engagement by 'stickers':

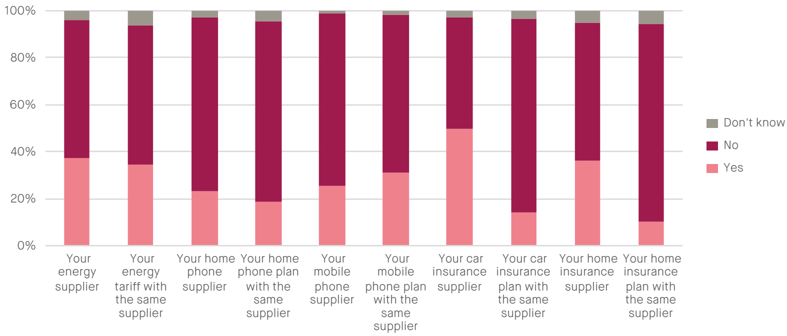
1. Consumers sticking with their provider may or may not switch their plan.
2. Consumers may or may not cite positive reasons for staying with their provider.
3. Consumers may or may not engage in other ways with the market.
4. Consumers may or may not report high levels of subjective loyalty.

1. A wider view of switching

Annual switching rates are the metric most commonly used to assess market performance from the demand side. However, it is a narrow view of engagement, excluding those who switch products with their providers.

Figure 4 shows that a significant share of consumers in all markets switch products or plans with the same provider in a three year period. Approximately as many consumers report switching product or plan as report moving provider. In mobile phones, consumers are more likely to switch their plan rather than their provider, which may reflect both loyalty to the brand (device and service) as well as perceived risks and hassle associated with switching provider. In energy and home phone, respondents are about as likely to switch either provider or plan. Only in insurance are consumers much more likely to switch provider. In the latter case this is likely explained by the nature of the contract (it is unlikely that consumers will imagine that they are switching 'plan' or 'product'). Switching plans is likely to exert competitive pressure on providers.

Figure 4: Proportion of consumers who switch provider and proportion that switch product in the last three years

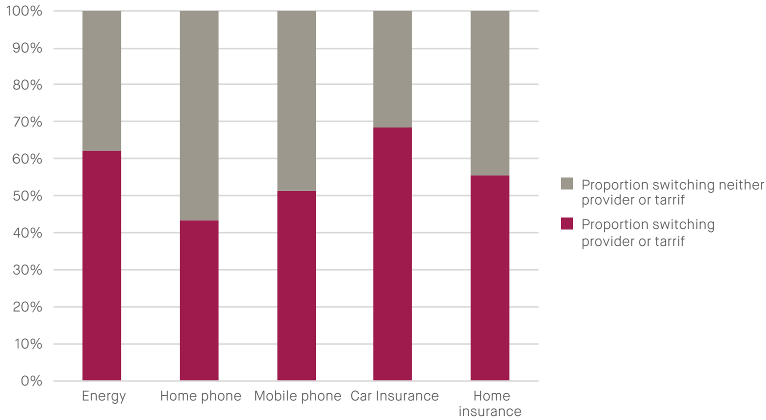


Source: Populus Survey for the SMF, excludes those respondents whom say 'not applicable'

The chart (Figure 5) below zooms in on those who switch either provider and / or product and gives a deeper understanding of market engagement. Only in one market do a majority of consumers report not switching over a three year period, namely in home phone. Six in ten of consumers in our survey report switching either their energy plan or their provider in the last three years.

This fuller view of engagement also puts into sharper relief non-engagement. Across all markets, a significant proportion of consumers have stayed on the same plan with the same supplier. This presents an important group for policymakers to target.

Figure 5: Proportion of consumer who switched provider or product in the last three years



Source: Populus Survey for the SMF, excludes those respondents whom say 'not applicable'

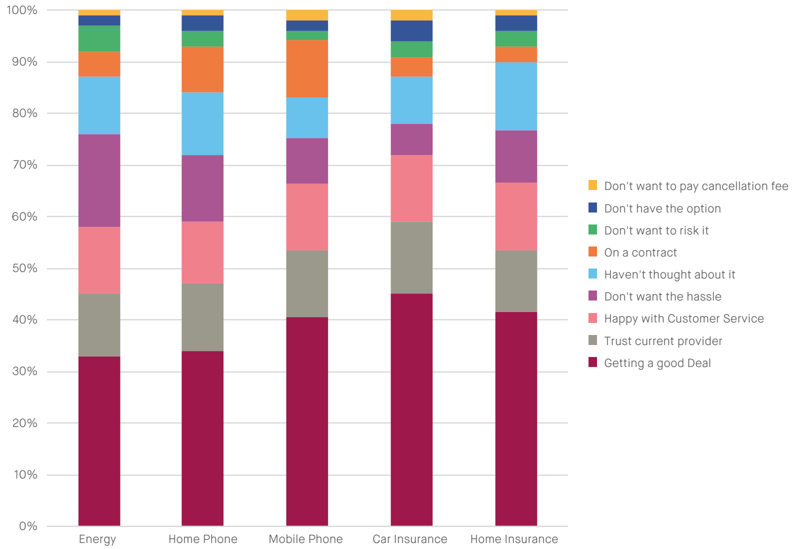
2. Why people stick with their provider

We can also develop a deeper understanding of 'stickers' by discovering why they chose to stay with their supplier. Figure 6 demonstrates that a majority of consumers that stay with their providers cite positive explanations as the 'main reason'. Positive reasons in our survey include: 'getting a good deal', 'happy with customer service' and 'trust current provider'. This result applies across all markets, with car insurance, mobile phone and home insurance displaying the highest rates of positive scores among 'stickers'. Such factors imply a level of positive 'loyalty'.

It is notable that a third of all 'stickers' across all five markets cite 'getting a good deal' as the main reason for staying with their current provider. Such results do not necessarily mean that consumers are getting the best deal. Some may not have tested the market. Others may be displaying an optimism bias in how they report their motivations.

In addition, consumers who report 'trusting' their provider may have incomplete information to make that judgement. It is notable for instance that a Citizens Advice survey found that a third of consumers believed that longstanding consumers of broadband services pay the same or less as new consumers, despite actually paying far more.[31]

Figure 6: What is the main reason you have stayed with your current provider? – consumers who have 'stuck' with their provider



Source: Populus Survey for the SMF, all those who have not switched provider in the last three years

Figure 6 also demonstrates that other consumers cite less positive reasons for not switching. Around one in ten had not thought about it (note, even though this covers a three-year period). This implies high levels of inertia and disengagement, and a lack of motivation to engage in decision-making and thus make it to phase one of the process.

Meanwhile, a significant minority report negative reasons for not switching, including not wanting the hassle, not wanting to take the risk, being on a contract, not having the option or facing a cancellation fee. These individuals face direct or perceived barriers to switching. For instance, 18% of energy 'stickers' cite the hassle of switching as the main factor why they have they not switched; a further 5% cite the risk of switching. These findings emerge despite the significant attempts by regulators to improve the switching process including the speed and the certainty of the outcome.

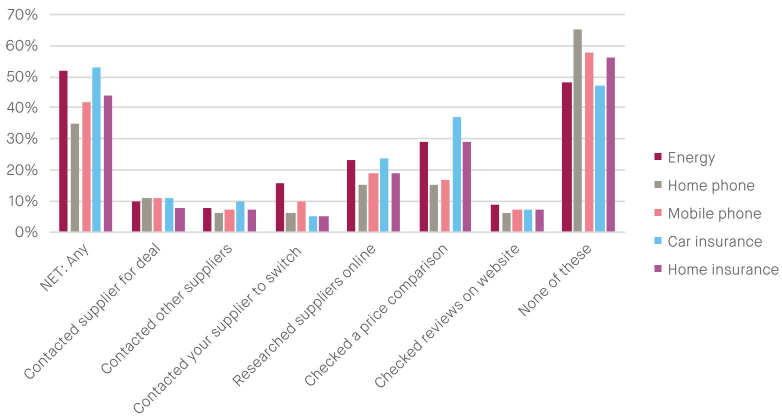
Around one in ten of consumers for mobile and home phone cite being on a contract as the reason they have not switched provider.

These findings demonstrate that there are significant obstructions that impede consumer's desire to exercise choice and pursue a better deal in the market.

3. Market testing and engagement

A third important indicator is the level of market testing taking place. Figure 7 reveals the proportion of our whole sample who report taking a range of engagement steps in the market in the last 12 months. It shows that between a third and half of all consumers have taken at least one step to engage in the market, whether this is using a price comparison website, contacting a supplier, or researching offers. It is unsurprising that online modes dominate in part because our survey was online. Perhaps more surprising are the high proportion of energy consumers who have tested the market in the last 12 months, which are on a par with market engagement levels in insurance.

Figure 7: Overall levels of engagement in the market by all consumers: 'Have you done any of the following engagement activities in the last 12 months?' by market



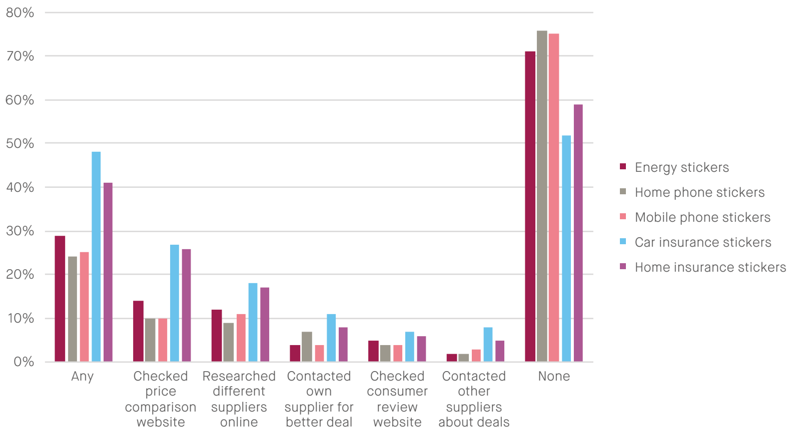
Source: Populus Survey for the SMF

It is also noteworthy that the prevalence of these activities dips when we look specifically at the behaviours of those who have stuck with both their provider and their product in the last three years (see Figure 8). A number of important conclusions can be drawn:

- A majority of such consumers have not engaged through any means in each market. They are unlikely therefore to know whether they are getting the best deal. Conversely, around three in ten have engaged in the last 12 months.
- The level of market engagement exhibited by 'Stickers' is lower than that of the wider population.
- There is significant variation between markets, with the lowest level of engagement evident in home phone and the highest level of engagement evident in insurance. There is, therefore, a strong correlation between the markets that display higher provider switching rates (over three years) and the markets that display higher levels of other forms of market testing. This may be explained in part by the annual renewal trigger which may activate some consumers to check the deals available in the insurance market. This hypothesis is supported by the comparatively high numbers of consumers who checked price comparison websites. Rates of switching in telecoms is low and those who have stuck with their provider and product in these markets are also unlikely to have tested the market in other ways.

It remains hard to assess the impact of these forms of market engagement either on individual outcomes or on competition in the market. Contacting suppliers is likely to contribute to the threat of switching that should theoretically stimulate competition and innovation among suppliers. Using price comparison websites should lead to better informed consumers. However, consumers may fail to complete the process because of risk aversion or behavioural biases that lead individuals to defer decisions.[32]

Figure 8: Proportion who have done any of the following engagement activities in the past 12 months – consumers who have stuck with both their provider and product for three years



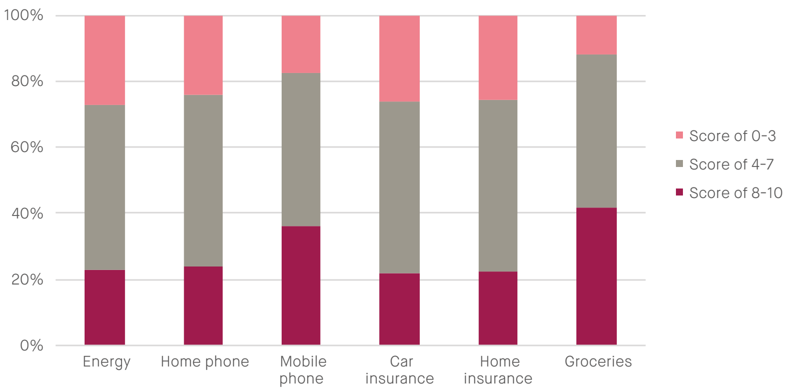
Source: Populus Survey for the SMF, consumers who have stayed with their provider and product for three years

4. Subjective loyalty

A final method of understanding behaviours and attitudes and the concept of loyalty is to ask consumers themselves. Subjective loyalty measures may capture a range of factors that contribute to consumer attachment to their provider. As well as reflecting satisfaction, the literature suggests that it is also influenced by the power of branding and the degree to which a brand becomes part of the consumer's identity. It is therefore a rounded measure of product satisfaction and emotional attachment to a company which plays a large role in people's desire to switch. The influences are likely to differ significantly across markets. In insurance, attachment is likely to be connected to people's trust that an organisation will pay out in the event of an incident. In mobile phone, brand and service reliability may be more powerful motivators.

Figure 9 records the proportion of consumers who give high or low loyalty scores in different markets. The grocery market receives the highest loyalty score, with more than four in ten consumers giving a score of 8, 9 or 10. This is unsurprising given the brand power of supermarkets and the fact that consumers may identify closely with their supplier. It may also reflect the fact that many supermarkets run loyalty or reward schemes that encourage customers to carry out repeat business. These features may be compounded by more recent developments associated with deliveries whereby consumers may commit to a particular supplier for the privilege of lower delivery costs.

Figure 9: How loyal do you feel to your provider of the following services?



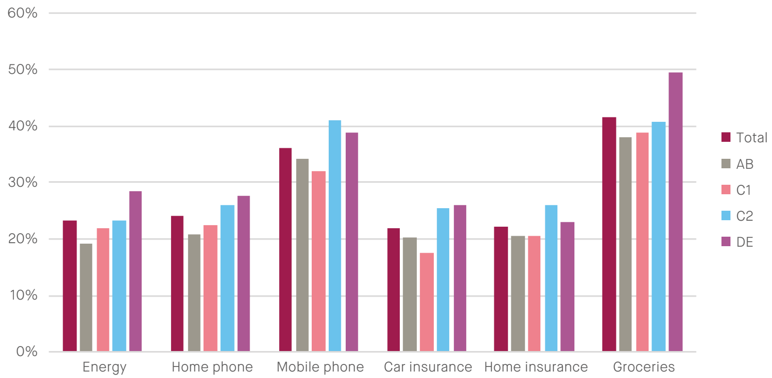
Source: Populus Survey for the SMF, excludes those respondents who say 'not applicable'

The mobile phone market has high levels of self-reported loyalty among consumers, nearer the levels of loyalty that consumers display in the groceries market than to energy, landline and insurance. This may stem from perceived lack of product differentiation in markets such as energy and insurance and the fact that consumers use their phones regularly. More generally, our survey analysis indicates that markets in which consumers feel high levels of loyalty to their providers also feel high levels of trust and have high proportions ready to recommend their providers.

Our survey shows that groups that are over-represented among loyal consumers (those who give a score of 8 to 10) include those from lower socio-economic backgrounds and (in many markets) older consumers. Research exploring other markets such as electronics, clothes and furniture has also shown that those aged over 65 are more likely than middle-aged individuals to register as 'loyal' in their behaviours.[33]

These systematic biases which make 'loyalty' more prevalent among otherwise more vulnerable groups suggests that policymakers should be reticent about encouraging the emotion.

Figure 10: Proportion of consumers reporting high levels of loyalty in each market (scores of 8-10) by socio-economic group



Source: Populus Survey for the SMF, excludes those respondents who say 'not applicable'

Summary of consumer engagement and loyalty

This market analysis has revealed that a majority of consumers have not switched their provider in the last three years across most consumer markets analysed (the exception being car insurance). Certain market characteristics including annual trigger points appear to affect differences across markets as well potentially as the ease of switching. Our survey results suggest that market outcomes for 'Stickers' are on average worse than for all consumers.

However, looking beyond switchers reveals a wide spectrum of behaviour among consumers that 'stick' with their provider. Differentiating simplistically between switchers and stickers is unhelpful as it ignores the spectrum of engagement behaviours exhibited by those that stick with their provider. In particular:

- A significant proportion of consumers report having switched their product or plan in the last three years. Indeed, a majority of consumers have switched either their provider or product in the last three years across all markets except home phone. This still leaves a significant minority who have done neither.
- A majority of non-switchers report positive reasons for not-switching such as the fact that they are 'getting a good deal'. This should be set alongside many consumers who report negative reasons, such as the hassle of switching and the risks associated with it.
- Depending on the market, between a quarter and a half of those who have not switched provider or product have tested the market such as by using price comparison websites, researching online or contacting suppliers.
- A significant minority of consumers report being loyal to their supplier across all markets.

Policymakers should be particularly concerned about certain sub-groups, including: those who do not engage at all (either by switching provider, product or by testing the market); and, those who cite perceived or direct barriers to switching, such as hassle, risks, costs and contracts.

The next chapter describes how policymakers can help stickers get a better deal.

CHAPTER 3: POLICY ANALYSIS

As noted in Chapter 1, attempts simply to activate higher switching rates are important though not sufficient. Switching rates in many markets have risen only modestly.[34] At the same time, this analysis has revealed that policymakers need to worry actively about the outcomes for loyal consumers. Those who don't engage in the market are at risk of being charged more for the same service. Interventions should be considered in the context of analysis from Chapter 2 which illustrated the heterogeneity of 'stickers', ranging from 'active loyal' consumers who may switch products, test the market and / or stay for good reason, through to consumers who are entirely disengaged.

It is easy to ignore the inherent dilemma for policymakers. Interventions must help address the penalty that loyal consumers often face without fatally undermining the incentives to switch and the parts of the market that are functioning competitively. Superficially attractive schemes such as rewards for loyalty are unlikely to strike this balance effectively. In the first place, any rewards that are offered must be paid for by other consumers in the market. Hence, a loyalty reward quickly becomes a subsidy from 'switchers' to 'stickers'. Second, as discussed below in more depth, rewarding inertia is likely only to entrench disengagement. Third, in its worst guise such a policy could become a further tool for exploitation of inactive consumers if the reward on offer does not match the best deal on the market. Given the fact that older consumers are more likely to report as 'loyal' in our survey, any such policy may hit particular vulnerable groups.

While encouraging or requiring loyalty discounts or rewards may inadvisable, there are policies that can help. The broad principle that competition should drive prices down and quality up is accepted and promoted by the Conservative Party in its Manifesto: 'Tackling living costs must mean making consumer markets work fairly. Markets should work for consumers, as well as producers – with competition keeping prices low and encouraging new product development.'[35] Below we describe how policy can be developed to promote a fairer and more competitive market.

1. SAFEGUARD TARIFF CAP

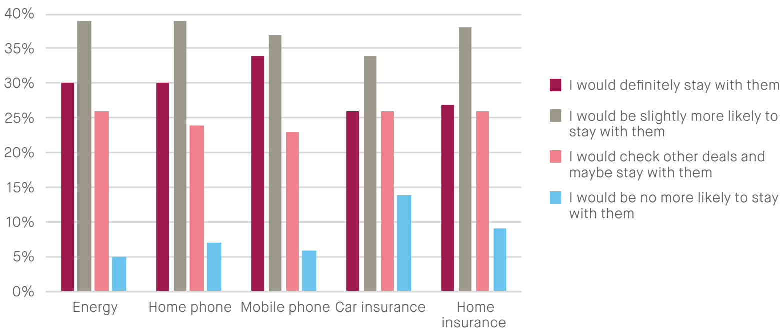
In its manifesto, the Conservative Party committed to introduce a 'safeguard tariff cap' in the retail energy market. It proposed this in response to 'a two-tier market, where those constantly checking for the best deal can do well but others are punished for inactivity with higher prices'. It noted that those hit worst are the poorest, those with lower qualifications, renters and the elderly. Specifically it proposes a cap that 'will extend the price protection currently in place for some vulnerable customers to more customers on the poorest value tariffs'. The Queen's Speech repeated this message and that the Government was considering whether to pursue this through action by the regulator or legislation.[36] Subsequently, the Government wrote to Ofgem asking it to consider how it could help safeguard consumers on the poorest value tariffs using its existing powers. Ofgem has since consulted with consumer groups and the industry on how best to take measures forward.

Thus far there is little detail on the number of individuals that will be affected by this policy. However, by way of contrast, the price cap introduced for consumers with energy prepayment meters impacts more than 4 million customers and will reduce costs by between 10% and 15% on average.[37]

While the problems in the market have been identified clearly by the CMA, Ofgem and others, price capping does not present the best mechanism for ensuring good deals across the market. The CMA report of 2016 found against the idea of a price cap. The majority view of the CMA panel was that the 'disadvantages of attempting to address the detriment of all customers on the standard variable tariff through a price cap would likely be disproportionate.' The review cited the 'excessive risks' of undermining competition which would worsen outcomes for consumers in the long-term, by reducing the incentives of suppliers to compete, reducing the incentives of customers to engage and increasing regulatory risk.[38] Potential risks identified by others include the difficulty of setting the cap, the negative effect on competition and innovation and the risk of undermining investment in the market.[39]

This is not the place for a full analysis of the implications of a price cap.[40] But, what can be said is that it is very likely to act against competition and engagement in the market. First, consumers may interpret the regulation as a signal that they do not need to seek out the best deal in the market (because they assume that the regulation is ensuring that they are getting a good deal). This is likely to reduce the urge to engage in the market. While our polling was carried out before the cap was proposed, we did ask respondents how they would respond to a loyalty bonus. The results, shown in Figure 11, reveal that across all markets studied a majority would be more likely to stick with their provider. Only a minority (around a quarter) would check other deals before doing so, whilst a small proportion said that they would be no-more likely to stay with their provider. The conclusion we draw is that when consumers think their interests are being looked after they are less likely to feel the urge to engage.

Figure 11: What would you do if your provider offered you a cash discount to stay with them in each of the following markets?



Source: Populus Survey for the SMF

Second, evidence from other markets suggests that in some cases firms may implicitly collude on prices if consumers believe that their interests are being protected. For instance, the stakeholder pension product had a capped cost of 1% and providers typically set their fees at the maximum rate; a study of the effect of interest price restrictions in Colorado found that 'charges gravitated systematically toward the price ceiling over time'.[41]
Third, by capping prices, the reduction in variation straightforwardly reduces the incentive for consumers to engage and to seek out the best deal because the upside of switching is smaller. The direction of this effect is clear in an economic sense, although how it may manifest itself is less

clear. As James Plunkett from Citizens Advice notes, switching rates have not risen as the savings from switching have grown.[42] However, research produced by the Centre for Competition Policy has found evidence that the size of savings does affect switching probability.[43] This may be accentuated if firms increase the price of their best deals to offset the loss of revenue from their standard tariffs.

Ultimately, a cap may risk a downward spiral of engagement and a reduction in competition. This risk is particularly prominent given the political difficulty that any government is likely to face in removing the cap.

Making the cap fit

Devising policy to mitigate these risks as far as possible will be important if any price cap is introduced. Steps could include:

1. **Devising an exit strategy now before the cap is introduced.** Analysis of price caps in other countries has shown that in many cases safeguard tariffs do not rise in line with costs over time thus presenting problems for competition and investment.[44] This may in part result from implicit or explicit political pressures which make it difficult to raise the cap. For the same reason it may be hard to remove any cap because the losers can easily identify the loss whilst the gains may be less immediately tangible.[45]

   Therefore, it would be advisable to set an end date for a cap. The time limit could be linked to the implementation of new remedies. For instance, the cap on prepayment meter tariffs will function for a transitional period from 2017 to 2020.[46] The Conservative Party has announced that it will carry out a review of the market and this would create a natural trigger for phasing out the cap with new remedies replacing the cap.

2. **Thinking carefully about the scope of the cap.** There are two related arguments against protecting all 20 million SVT consumers with the cap. First, more consumers will directly feel the disincentive to engage. Second, regulatory protection would become the norm in the market. As our analysis and that of others has shown, there are particular groups that we should be worried about:

a. Those who have limited capability or capacity to engage in the market, such as the very old. This principle could be said to be applied in telecoms with Ofcom cutting the tariff of BT landline-only consumers.

b. Those for whom high energy costs have the most severe consequences – such as those on low incomes and the old. This could include for instance targeting recipients of the Warm Home Discount or Pension Credit.

c. Those who are most disengaged and least likely to be activated by other market interventions – for this group the downside is smaller and the upside larger. This could for instance cover those who are on SVTs and who haven't switched provider or product for three years. As our analysis demonstrates, there is crossover (albeit imperfect) between the most disengaged and the most disadvantaged households.

3. **Devising market-based reforms that drive better value for money.** It will important to establish complementary policies that will reduce the need for any price cap intervention over time.

4. **Retaining an element of competition.** The cap should be set so as to provide room for competition. As is the case of the cap for prepayment customers, the level should be set to so that there is room for suppliers to price below the cap.[47]

The Conservative manifesto contains the germs of many interesting ideas, including strengthening the hand of regulators, of consumers and of consumer voice; and a duty on regulators to weigh up needs of vulnerable consumers. With these in mind, we describe steps that could be taken in energy and other markets to promote engagement and ensure that loyal consumers get a good deal in the market.

2. MOBILISING ENGAGEMENT VIA PROVIDERS

Our analysis shows that there is a wide spectrum of engagement in the market among switchers and stickers. Below we discuss potential approaches that the Government and regulators could adopt. We envisage the more light-touch measures could be introduced first before scaling up to more interventionist policies if a market continues to display problems.

Step 1: Making the best deals available to loyal consumers

Loyal customers currently miss out on deals only made available to or promoted among new customers across a range of markets. Recent media stories suggest that some energy providers bar existing clients from accessing their best deals, reserving them for new customers.[48] New-customer-only deals were banned by Ofgem but have subsequently been permitted again following the CMA review on the premise that it would drive more competition. Some financial service providers have also been accused of reserving special rates for new customers.[49] It is unclear that the availability of all deals to all customers would significantly undermine competition given the fact that we may not expect (all other things being equal) that large numbers would take advantage of this. Conversely, at a basic level, making such deals available to existing customers could be considered a basic tenet of 'fairness' in the market.

Ofgem opened a consultation in August 2017 on default tariffs available to consumers at the end of fixed-term contracts. The consultation is asking responses to the proposal that suppliers should be able to roll customers onto another fixed-term tariff at the end of their existing deals as long as the new product does not have termination fees, is not more expensive than the default SVT and is appropriate for the consumer.

Step 2: Providing fuller information on the costs of loyalty

Better information on pricing could also go some way to help loyal consumers. Research commissioned by the FCA found that putting last year's premium on renewal notices caused between 11% and 18% of home insurance consumers to switch or negotiate for a better deal.[50]

In mortgages, providers must provide an APR (annual percentage rate) which calculates the total interest cost over the 25-year term, plus any fees. This principle could be applied to other markets such as broadband, television and other services so that these are incorporated in the headline price that is quoted.

It should be noted however that individuals may be over-optimistic about the likelihood that they will switch at the end of the contract and some consumers may therefore still take on a contract even when they can observe the higher costs that kick-in at the end of the initial deal period.

Step 3: Mobilising social pressure through transparency

Providers are well-placed to initiate engagement with their existing customers and certainly better-placed than government or other intermediaries. However, too often it is not in the short-term interest of suppliers to take such steps. Therefore, Government and regulators could make it more attractive.

Social pressure can encourage businesses to behave in a pro-social manner if the requisite information is made available and transparent. Examples include the Living Wage campaign which has encouraged a growing number of organisations to seek accreditation as Living Wage employers. Transparency has been used to drive good corporate culture and to help address the gender pay gap.[51] As a mechanism for intervention it has the benefit of being light-touch.

The aim should be to apply pressure so that suppliers feel a social requirement to reform practices that contribute to consumer detriment, including how they treat consumers that stay loyal. In other words, suppliers feel that their reputation (and ability to win and keep customers) would be damaged if they did not alter their practices. A beneficial by-product may be that this information could also help consumers in their decision-making.

It is possible to identify possible interventions across a range of consumer markets which could shine a light on how loyal consumers are being treated:

- In energy, suppliers could be required to publish data each quarter on the number and proportion of their consumers who are on Standard Variable Tariffs.
- In broadband services, providers could be obliged to publish data regularly on the proportion of their consumers on out-of-contract deals which are typically significantly much more expensive.

- In the mobile phone market, suppliers could be forced to publicise data on the proportion of consumers on off-handset deals.
- In insurance, providers could be required to tell prospective consumers what proportion of their existing customer base paid more when they renewed their policy.

Featuring this information on bills, on the websites of regulators and in the media could potentially shame poor-performing suppliers into changing their practices. Such data could be provided under a heading such as: 'This is how we treat loyal customers'.

Step 4: Setting providers targets

A more muscular intervention would be for the Government to set providers a target for reducing the proportion of consumers who are on expensive default products.

For instance, the Government could require that each energy supplier hits a target of reducing the proportion of consumers on SVTs. Ofgem data from late 2016 shows that the proportion of consumers on SVTs varies significantly between providers: among the large providers, the lowest proportion was 50%, and the highest was 91%.[52] Given very different starting points, it would be important to provide certainty and time to adjust. With an end date of 2020, providers could be required to reduce the proportion of their consumers on SVTs to a given level (e.g. 30%). Suppliers that did not achieve these targets would be penalised through a fine.

This would have the important effect of encouraging providers to drive engagement with their customers as a route to encouraging them to switch product.

We recommend that this idea should be explored by Ofgem as it considers the request from the Government to consider the future of SVTs.[53]

In other markets, providers could be given targets relating to the proportion of consumers that receive compensation due them (this would drive the move to automated compensation e.g. in telecoms) or to reduce the proportion of consumers on out-of-contract deals.

3. DEFAULT MECHANISMS FOR THOSE WHO REMAIN DISENGAGED

The steps set out above could help incentivise providers to engage their consumers as well as help protect the interests of consumers who stay loyal to their providers.

Below we describe a more interventionist measure to address disengagement. We envisage that this policy could be introduced when any price cap ends.

Our analysis indicates that there is a diverse spectrum of engagement behaviour among 'stickers'. While we draw attention to individuals that engage in the market and test the market whilst sticking with their providers, there are also many who exhibit inertia and disengagement. Below we describe a measure that could offer a market-based protection to vulnerable consumers. Importantly, such a measure would act as a powerful incentive on suppliers to engage their consumers and get them off SVTs.

In 2015, the SMF put forward the idea of a reverse auction for energy consumers.[54] The concept may be amenable to the energy market because there is less product differentiation than in other markets. In the long-term, reverse auctions could be facilitated at a household level through fully-functioning smart meters which could provide real-time data on usage. In the short to medium term this idea could be pursued as a collective auction with individuals who remain stuck on default products put into a central pool of consumers, whose demand for energy is auctioned off. The idea has more recently been put forward by academics at the Centre for Competition Policy.[55]

We envisage two versions: an opt-in and an opt-out. We propose that policymakers and regulators graduate up from the first to the second.

Designing an opt-in auction

We propose that the Government should consider the following process:

1. **Selecting the default group:** This group could include those who have not switched provider or plan for three years or more and are on a SVT. This definition of 'disengagement' was put forward by the CMA in its market review, with the intention that a database of such consumers would be created so that rival firms could pitch for their business.[56] The infrastructure for identifying these consumers already exists.

2. **Opt in:** Consumers in the default group would be presented with an alternative price which derived from the best price attained through an auction process. The consumer would be prompted to choose between this new 'Best in Market' price and their existing deal. This would include a tangible figure for the level of cost saving compared to their current deal. Consumers should be able to opt in at a click of a button. This could be a catalyst for future engagement among these consumers as they participate in the market by 'opting in'.

   All communication would be organised and fronted by the Government or Ofgem rather than by providers. This would add credibility to the process.

3. **Running the auction:** The scheme would be run and coordinated by Ofgem.[57] The auctioneer may choose to parcel consumers into sub-groups to ensure that the contracts are not excessively large and so that smaller providers are able to bid to win the work. The auctioneer would have to establish minimum quality requirements for any bidders.

4. **Repeating the auction:** The process would be repeated every year.

Implementation considerations:

- Introducing such a scheme need not be excessively time-consuming as there are already collective switching initiatives. Certainly there is no reason why such a scheme could not be developed during the period when the safeguard tariff is in place. Indeed, such an alternative scheme could provide a compelling offer for politicians to sell to the public when the cap is removed.

- This principle may be suitable for other markets where product differentiation is minimal and where quality is a lesser consideration, for instance aspects of telecoms.
- There is a risk that the price achieved through the auction is higher than the very best deals in the market.[58] However, it seems extremely unlikely that individuals on SVTs would not receive a better deal than they currently achieve.
- Once the auction process has been run once, suppliers that participate in the auction should have a reasonable sense of the proportion of consumers who opt-in to the scheme. Ahead of the first use of this scheme, Ofgem should carry out a pilot to assess the proportion of consumers who would opt-in. This would provide better information to suppliers on the number of clients up for grabs in the auction.

Designing an opt-out auction

We envisage that an opt-in scheme (such as described above) would mean more consumers benefiting from a better deal. However, it is likely that some consumers would not ‘opt in’ even if it were in their best interests.

This problem could be addressed by using an ‘opt-out’ scheme rather than an ‘opt-in’. An ‘opt-out’ scheme would mean that all consumers in the default group would automatically be enrolled into the auction scheme unless they purposefully opted out in favour of remaining with their current supplier or moving to a third party of their own volition. This approach would bear similarities to the auto-enrolment of employees into workplace pensions. Such an approach has been adopted elsewhere, including New Jersey where residents are automatically enrolled into the Energy Aggregation Program although they can opt out if they like.[59]

As with auto-enrolled savers, the government becomes ultimately responsible for the outcome for consumers. Potential risks that a provider could go bust could probably be managed and mitigated: consumers could be parcelled into smaller lots and there is already a ‘safety net’ operated by Ofgem for consumers whose supplier goes bust. The Government would have to set strict benchmarks that participating suppliers would have to demonstrate (e.g. quality of service and track record).

However, a more fundamental dilemma is that the state would be assuming responsibility for the consumer's outcome. While in an opt-in scheme, responsibility would ultimately sit within the consumer, an 'opt-out' scheme would be quasi-mandatory and therefore the responsibility would sit with the government. For this reason, it is likely that the government would need to take forward legislation. We believe that an 'opt-in' scheme should be tested first, allowing further time for Ofgem and the Government to assess the implications of adopting an 'opt out' scheme.

3. PROMOTING SWITCHING

The proposals in this report focus primarily on ensuring that those who stick with their provider are not exploited and do not miss out on the best deals. However, the threat of consumers switching ultimately drives suppliers to offer the best deals to their consumers. Moreover, Chapter 2 demonstrated that, despite repeated efforts by the government, many consumers are still put off switching due to the hassle and associated risks. This is true across many markets.

The Conservative Party is committed to continuing to support 'initiatives to make the switching process easier and more reliable' in energy. This will require concerted action. Lessons could be learnt from markets that exhibit higher levels of switching such as insurance and consideration given to whether annual renewals can be replicated in other markets.

Reducing the costs of switching

Modelling of consumer switching by Oxera has demonstrated the range of factors that determine consumers' decision whether to switch. These include rational factors such as time spent switching versus amount saved by switching and the perceived risk associated with switching as well as behavioural factors such as loss aversion.[60]

Our own survey showed that risks associated with switching stop some consumers from taking action. The wider use of consumer data through MiData, Open Banking and Smart Meters in energy should help reassure consumers that the new deal they are signing up to matches their actual consumption patterns and needs.[61]

Creating renewal triggers

The research has shown that switching rates are highest in markets (e.g. insurance) where there is a built-in annual renewal point. This may be difficult to apply in all markets but in non-essential services such as entertainment, rollover contracts could be restricted. Auto-renewal practices could be banned except in instances where the customer explicitly gives permission.

Introducing an 'Active Consumer Week'

Previous SMF research has proposed that there would be advantages to raising awareness of the benefits of changing provider or product across a range of markets through an Active Consumer Week. This might also help to establish consumer engagement as a social norm and something that 'people like me' do.[62]

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Stick or Switch?

Making markets fairer and
more competitive

At the heart of the debate about 'fair markets' is concern about the outcomes for consumers who don't switch but stick with their suppliers and subsequently pay a so called 'loyalty penalty'. This report focuses on such 'loyal' consumers and explores who they are and how they behave across a range of markets. It draws on new consumer polling to reveal a wide spectrum of behaviour ranging from the 'actively loyal' through to the 'inert and disengaged'.

The paper goes on to analyse how to promote engagement in the market and help such consumers get a better deal without undermining competition in the market more generally.

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