Loyalty penalties and the limits of competitive markets

In December 2018, the UK Competition and Markets Authority (CMA) published its response to a Citizens Advice super-complaint relating to “loyalty penalties” – referring to a practice whereby customers who remain with a provider pay more than a new customer. The CMA found that UK companies were “exploiting” loyal customers with “rip-off” charges amounting to billions of pounds. This bulletin assesses the logic underpinning this judgment and explains why both the super-complaint and the CMA’s response raise important questions about the wider role of competition across a range of sectors.

In its super-complaint, Citizens Advice identified that loyal customers pay up to £4bn a year more in the mobile, broadband, home insurance, savings account and mortgage markets than they should. The CMA endorsed this assessment in its response. The CMA also found that:

- “vulnerable people” – including the elderly and those on low incomes – may be more at risk of paying the loyalty penalty;
- firms were employing a range of tactics to “rip off” and “exploit unsuspecting customers”, ranging from “stealth price rises” to “requiring customers to auto-renew or not giving sufficient warning that they will be rolled over” onto a higher-price contract; and
- the loyalty penalty is likely to arise in many other markets in addition to those it had investigated.

The CMA has made several recommendations to regulators and government based on these findings. Perhaps the most eye-catching are that:

- regulators publish the size of the loyalty penalty in key markets and for individual suppliers on a yearly basis; and
- targeted price caps should be introduced to protect those worst affected by the loyalty penalty, such as the vulnerable.

Both the super-complaint and the CMA’s response raise important issues of economics and policy, which I set out below.

One man’s meat…

A first observation is that the flipside of a loyalty penalty is an introductory offer. A firm that offers a discounted price for the first month to attract new customers is in effect simultaneously imposing a loyalty penalty on any customer who remains with the firm beyond the first month.

In a survey, Citizens Advice found that 96% of those canvassed thought providers of essential services should charge loyal customers the same as or less than new customers. It would be interesting to run a similar survey asking the question “Should firms be prohibited from giving new customers a short-term special deal to encourage them to try the product?” and see whether 96% of respondents answer “yes”.

In addition to saving money for customers who choose to take them up, introductory offers can play a key role in encouraging consumers to consider their choice of provider, thereby stimulating competition. Perhaps for this reason, the CMA stopped short of explicitly calling for a ban on introductory offers. However, it is difficult to see how the loyalty price caps that it is recommending will not restrict the scope for such offers in a competitive market environment. We unpack the reasons for this below.

£4bn of higher prices?

The basic logic underpinning the £4bn loyalty penalty estimate outlined by Citizens Advice and CMA is as follows.

1. Firms offer a product which takes the form of a long-term service relationship unless actively severed by the customer (e.g. a savings account, a broadband contract).
2. Customers face some switching costs if they move to a new provider – it takes time and it's a hassle - so have a tendency to stick with their existing supplier.
3. Firms recognise that once they have won a customer they will be able to price above the competitive level without losing their business. The "excess" that firms charge is determined by the level of the switching costs.
   a. For instance, suppose the product costs 100 from any provider (this is the competitive/zero profit level), and switching costs for a customer are 10.
   b. Firms would be able to charge an existing customer 10 above the competitive price because it wouldn't be worth their while jumping to a rival.
   c. In this situation, firms make 10 profit on existing customers.

This is the source of the loyalty penalty concern. In other words, the penalty is calculated by taking the difference between the price paid on an introductory offer and the standard variable rate to which the customer is migrated once the offer has expired. However, the economic logic does not stop there.

4. Firms will recognise that if they win a new customer they will ultimately be able to charge them 110 and so make 10 profit. They are therefore prepared to offer a discount of up to 10 to attract new business.
5. Competition drives the level of the introductory discount to 10. If one provider offers an initial discount of less than 10, a rival would be able to offer slightly more and so attract that customer. This process continues until the upfront discount exhausts all the subsequent profits.
6. At an introductory price of 90, a final price of 110 is not sustainable as it would provoke customers to switch (the difference of 20 is greater than the switching costs of 10). Firms therefore reduce their end prices to 105 and continue to discount by 10 for an introductory price of 95.
7. Overall:
   a. Firms make zero (i.e. competitive) profits.
   b. On average, consumers pay competitive prices.
   c. However, there is a distributional issue. Consumers who switch regularly receive more introductory offers and so pay a sub-competitive price. Consumers who rarely switch receive few introductory offers and so pay a higher-than-competitive price.

One might think that all long-term customers could save 10 by switching from the high-end price of 105 to the low introductory offer of 95. This logic is the basis of the Citizens Advice figure of £4bn in potential savings.

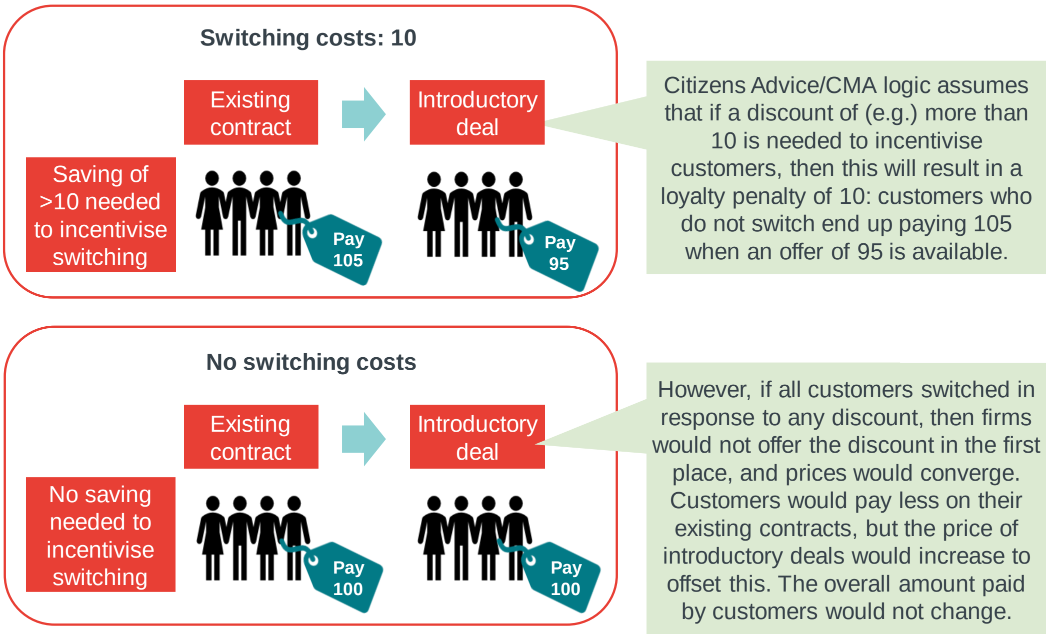
However, if we take the Citizens Advice argument a bit further, the £4bn saving disappears.

8. Recall that the reason the introductory discount exists is because a new customer will become a long-term source of profit in the future. In other words, it is the high long-term price of 105 that leads to the starter discount of 95.
9. If all customers switch as soon as they are moved to the higher price, there is no long-term profit to be gained and so no benefit to competing hard to get new business in the first place – there will be no introductory offers. In this case, the long-term price falls to 100 and the introductory price increases to 100.

10. In these circumstances, firms still make zero profits and customers on average pay competitive prices, but there is no distributional difference.

This logic suggests that the mooted £4bn in higher prices is unlikely to exist in practice.

Figure 1: Illustration of issues with the logic underpinning the loyalty penalty estimate put forward by Citizens Advice and the CMA



Source: Frontier Economics

We've been here before

The idea that there is a large benefit to be gained if only all customers could pay the lower introductory price rather than the higher long-term price is seductive. The CMA employed similar arguments in its Retail Energy Market Investigation, which found a consumer detriment of £1.4bn per year. Likewise, an Occasional Paper by the Financial Conduct Authority on the subject of the savings market concluded that an average saving of £300m could be realised if providers were required to set only one price.

If these arguments held water, a market remedy designed to cap long-term prices or to encourage switching would lead to substantial benefits for consumers. However, the logic set out above suggests that any attempt to reduce the long-term price would simply lead to an offsetting reduction in the level of any introductory discount. There would be no clear net benefit to customers as a whole.

Given this, the UK government's introduction of a price cap on retail energy default (i.e. long-term) tariffs is likely to lead to a commensurate reduction in the level of introductory discounts, with perhaps a one-off gain to consumers who are currently on long-term deals and who would never switch. This may not constitute the dramatic welfare improvement that the government is hoping for.

A problem *of* competition – not a problem *with* competition

The debate about loyalty penalties is typically phrased as being the result of a problem with competition. (This is partly owing to the UK Enterprise Act's insistence that the CMA must remedy features that give rise to an "adverse effect on competition" in a market investigation.) But it is perhaps more helpful to think of loyalty penalties – or, equally, introductory offers – as being the direct *outcome* of effective competition in a market characterised by long-term products, and consumers who need some incentive to encourage them to switch suppliers.

Seen in this light, the debate shifts from whether there is some impediment to competition in these markets to a deeper issue - namely that competition, *even working properly*, may not produce results that are in the interests of all consumers. In particular, these markets tend to have uneven distributional outcomes: customers who do not switch regularly pay higher prices than those that do. Citizens Advice and the CMA have both argued furthermore that those who pay more are disproportionately likely to be “vulnerable”, insofar as they are often older, poorer or otherwise disadvantaged.

It is important to stress that these outcomes are not a problem of a lack of competition. Competition, working well, will give rise to exactly this situation. However, competitive markets may not always produce results that are seen to be satisfactory or fair in a wider policy perspective. This challenges the assumption that if only markets were sufficiently competitive, they would deliver optimal outcomes.

Where do we go from here?

The policy question, then, is whether it is possible to intervene to tackle such issues in a way that the benefits outweigh the costs. The approach that competition authorities have traditionally taken is to improve the information available to customers and to reduce any barriers to switching so that people can take advantage of the keenest prices in the market. A number of the remedies that the CMA has set out in its response to the super-complaint – such as its recommendation that regulators publish more details of the size of loyalty penalties in their respective industries – follow a similar pattern.

If these types of policies were effective, one would expect to see a narrowing in the gap between long-term and introductory prices. However, this does not seem to have occurred to date. The super-complaint argued that this is essentially because switching costs, particularly for vulnerable consumers, are inherent in these markets (e.g. because of the time needed and inconvenience caused). Citizens Advice’s proposed remedies – which the CMA has now endorsed in its response – include promoting collective switching, caps on long-term prices, and price differential caps (i.e. caps on the difference between introductory and long-term prices). The charity network also suggests there may be merit in targeting these remedies at more vulnerable customer groups, if they can be identified.

A key question is whether such remedies would have negative repercussions. The logic above suggests that price caps or price differential caps would leave the average price paid by customers unchanged, so any benefit would have to arise from better distributional consequences. Against this, one would need to offset any further adverse effects. For instance, a price cap or price differential cap would likely reduce the level of switching, diminish the benefits of innovation and make it more difficult for new firms to attract customers. In short, the danger is that competition would be weakened. If so, one would need to trade off the distributional benefits of a remedy with the possibility that prices to customers overall may increase.

These trade-offs are now being played out in the energy retail sector, making it an interesting test bed. Following its investigation into the sector, the CMA refrained from capping default retail energy tariffs because it was concerned about the impact it might have on competition. However, the UK government has pressed ahead and introduced such a cap, which came into force this month. Regulators and policymakers would be well advised to pay close attention to energy customer switching rates and the performance of smaller suppliers in the sector (eight of which went bust in 2018 alone, even before the introduction of the cap) to see if concerns about the impact of the cap on competition are borne out in practice.

The limits of competition interventions

The CMA’s aim, as set out on its website, is “to make markets work well for consumers, businesses and the economy”. The discussion in this bulletin suggests that this target may be more controversial than one might think. Competitive markets may not give rise to outcomes that are beneficial to *all* consumers, even if they are beneficial on average to consumers as a whole.

It is therefore worth considering whether competition interventions are the appropriate response to the issues discussed here, given the potential adverse consequences. It may be that wider reforms to the tax and benefits system are the best way to address distributional concerns.

It will also be interesting to see how public attitudes to the role of competition in energy markets evolve with the cap in force. In early February, Ofgem announced that the level of the cap for a typical customer would be raised by £117 a year – or about 10% – in April, due primarily to substantial increases in wholesale energy costs, illustrating how prices can still increase substantially even after concerns voiced about overcharging have been explicitly ruled out by regulatory intervention. Whatever the veracity of the claims made about the customer savings brought about by the price cap – Ofgem argue that customers would have paid even more had the cap not been in force – the hard reality that default prices can increase significantly even with the cap in force may cause some consumers to look again at the advantages of engaging in the market and shopping around.

David Parker
+442070317000
david.parker@frontier-economics.com